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(Continued)

§ 1.371–2 *Exchanges by security holders.*

(a) *In general.* (1) Section 371 (b) prescribes the rules relative to the recognition of gain or loss upon certain exchanges made by the holders of stock or securities of an insolvent corporation in connection with a reorganization described in section 371 (a). Under section 371 (b) (1), no gain or loss shall be recognized if, pursuant to the plan of reorganization, stock or securities in the insolvent corporation are exchanged solely for stock or securities in the corporation organized or made use of to effectuate such plan. If, in addition to such stock or securities, other property or money is received upon such exchange, gain is recognized to the extent of such other property or money (section 371 (b) (2)), but no loss is recognized (section 371 (c)). As to the basis of the stock or securities or other property acquired upon an exchange under section 371 (b), see section 358.

(2) By thus characterizing as an exchange, and regarding as a single taxable event, the event or series of events resulting in the relinquishment or extinguishment of the stock or securities in the old corporation and the acquisition in consideration thereof, in whole or in part, of stock or securities in the new corporation, the Code secures uniformity of treatment for the participating security holders, regardless of the particular steps or the procedural devices by which such exchange is effected. Thus, the transaction which qualified as a reorganization under section 371(a) may take one of several forms. In a typical creditors' reorganization there may be a transfer of the property of the old corporation to its bondholders, or the bondholders' committee, upon surrender of the bonds, followed by the transfer of such property to the new corporation in consideration of stock in the latter; or there may be a transfer of the bonds to the new corporation in exchange for its stock or securities, followed by the transfer of the property of the old corporation in consideration of the surrender of its bonds. In either event, section 371 (b) treats the result to the participating security holders as an exchange of the securities of the old corporation for securities of the new corporation. In order, however, to qualify as an exchange under section 371 (b) the various events resulting in the relinquishment or extinguishment of the old securities and the acquisition of the new securities must be embraced within the plan of reorganization and must be undertaken for reasons germane to the plan. If the event, or series of events, qualifies as an exchange under section 371 (b), no antecedent event necessarily a component of the relinquishment or extinguishment of the securities of the old corporation in consideration of the acquisition of the securities of the new corporation shall be considered a transaction or event having consequences for income tax purposes.

(b) *Exchange solely for stock or securities.* Section 371 (b) (1) provides that no gain or loss shall be recognized upon an exchange consisting of the relinquishment or extinguishment of stock or securities in an insolvent corporation described in section 371 (a), in consideration of the acquisition solely of stock or securities in a corporation organized or made use of to effectuate the plan of reorganization. As used in this section, the term security does not include a short-term note.

(c) *Exchanges for stock or securities and other property or money.* If an exchange would be within section 371 (b) (1) if it were not for the fact that the property received in the exchange consists not only of stock or securities in the corporation organized or made use of to effectuate the plan of reorganization, but also of other property or money, then

(1) As provided in section 371 (b) (2), the gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of money and the fair market value of the other property. The gain so recognized shall be treated as capital gain.

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 371 (c)).

(d) *Records to be kept and information to be filed.* (1) Every taxpayer who receives stock or securities and other property or money upon an exchange described in section 371(b) in connection with a corporate reorganization, must furnish a complete statement of all facts pertinent to the recognition or nonrecognition of gain or loss upon such exchange, including—

(i) A statement of the cost or other basis of the stock or securities transferred in the exchange, and

(ii) A statement in full of the amount of stock or securities and other property or money received from the exchange, including any liability assumed upon the exchange. The amount of each kind of stock or securities and other property (other than liabilities assumed upon the exchange) received shall be set forth upon the basis of the fair market value thereof at the date of the exchange. The statement shall be incorporated in the taxpayer's income tax return for the taxable year in which the exchange occurs.

(2) Permanent records in substantial form shall be kept by every taxpayer who participates in an exchange described in section 371 (b), showing the cost or other basis of the transferred property and the amount of stock or securities and other property or money received (including any liabilities assumed upon the exchange), in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.

§ 1.372 Statutory provisions; basis in connection with certain receivership and bankruptcy proceedings.

SEC. 372. *Basis in connection with certain receivership and bankruptcy proceedings*—(a) *Corporation.* If property was acquired by a corporation in a transfer to which—

(1) Section 371 (a) applies,

(2) So much of section 371 (c) as relates to section 371 (a) (1) applies, or

(3) The corresponding provisions of prior law apply,

then notwithstanding the provisions of section 270 of the Bankruptcy Act (54 Stat. 709; 11 U. S. C. 670), the basis in the hands of the acquiring corporation shall be the same as it would be in the hands of the corporation whose property was so acquired, increased in the amount of gain recognized to the corporation whose property was so acquired under the law applicable to the year in which the acquisition occurred, and such basis shall not be adjusted under section 1017 by reason of a discharge of indebtedness in pursuance of the plan of reorganization under which such transfer was made.

(b) *Stock or security holder.* For basis of stock or securities acquired under section 371 (b), see section 358.

§ 1.372–1 Corporations.

(a) If, as the result of a transaction described in section 371, so much of section 371(c) as relates to section 371(a), or the corresponding provisions of prior law, the property of an insolvent corporation is transferred, in pursuance of a plan of reorganization, to a corporation organized or made use of to effectuate such plan, the basis of such property in the hands of the acquiring corporation is the same as it would be in the hands of the insolvent corporation, increased in the amount of gain recognized upon such transfer under the law applicable to the year in which the transfer was made. In any such case, the adjustments to basis provided by section 270 of the Bankruptcy Act (11 U.S.C. 670), or section 1017 of the Code, shall not be made in respect of any indebtedness cancelled pursuant to the plan of reorganization under which the transfer was made. If the transaction falls within the provisions of section 372 (a), the basis of the property involved shall be determined pursuant to such provisions, notwithstanding that the transaction might otherwise fall within another basis provision.

(b) The provisions of section 372 (a) are applicable in the determination of basis for all taxable years beginning after December 31, 1933, except that the basis so determined shall not be given effect in the determination of the tax liability for any taxable year beginning prior to January 1, 1943. With the exception indicated, the basis so prescribed is applicable from the date of acquisition of such property. For example, the provisions of section 1016 relating to adjusted basis shall be applied as if section 372 (a) were a part of the Internal Revenue Code of 1939 and prior internal revenue laws applicable to all taxable years beginning after December 31, 1933. Hence, in determining the amount of the adjustments for depreciation, depletion, etc., under the provisions of section 1016 (a) (2), the "amount allowable" is the amount computed with reference to the basis provided in section 372 (a).

(c) The effect of the application of section 372 (a) may be illustrated by the following examples:

Example (1). On January 1, 1935, the Y Corporation, a taxpayer making its returns on the calendar year basis, acquired depreciable property from the X Corporation as the result of a transaction described in section 372 (a). On January 1, 1935, the property had, in the hands of the X Corporation, a basis of $200,000, an adjusted basis of $150,000, a fair market value as of January 1, 1935, of $80,000, and an estimated remaining life of 20 years. The 1935 transaction was treated as a taxable exchange and, accordingly, the Y Corporation claimed and was allowed depreciation in the amount of $4,000 for each of the eight taxable years 1935 through 1942, inclusive. For each of the twelve taxable years 1943 through 1954, inclusive, the Y Corporation claimed and was allowed depreciation in the amount of $7,500. On December 31, 1954, the property was sold for $10,000 cash. The amount of the gain realized upon the sale is computed as follows:

Basis to X Corporation		$200,000
Adjustment for depreciation in the hands of X Corporation (sec. 1016)		50,000
Adjusted basis for depreciation in the hands of both X and Y Corporations (sec. 372 (b))		150,000
Deduct:		
Depreciation allowable in amount of $7,500 per year (1/20 of $150,000) for 8 years, from Jan. 1, 1935, through Dec. 31, 1942	$60,000	
Depreciation allowable Jan. 1, 1943, to Dec. 31, 1954 (12 years at $7,500)	90,000	150,000
		0
Adjusted basis for computing gain or loss		10,000
Sale price		10,000
Gain realized		

For the taxable year 1943 and succeeding taxable years, the Y Corporation is entitled to deductions for depreciation in respect of such property in the amounts of $7,500 in the determination of its tax liabilities for such years. But no change in the tax liability is authorized for preceding taxable years by reason of the difference between the $7,500 depreciation allowable and the $4,000 deduction previously allowed.

Example (2). Assume the same facts as in example (1), except that the property acquired by the Y Corporation had a fair market value as of January 1, 1935, of $180,000, instead of $80,000, and the Y Corporation claimed and was allowed depreciation in the amount of $9,000 for each of the eight taxable years 1935 to 1942, inclusive, and in the amount of $6,500 for the taxable years 1943 to 1954, inclusive. In such case, the amount of the gain realized upon the sale of the property would be computed as follows:

Adjusted basis for depreciation in the hands of Y Corporation as computed in example (1)		$150,000
Deduct:		
Depreciation allowed in the amount of $9,000 per year for 8 years Jan. 1, 1935 to Dec. 31, 1942	$72,000	
Depreciation allowable Jan. 1, 1943, to Dec. 31, 1954, inclusive (12 times $6,500)	78,000	150,000
		0
Adjusted basis for computing gain or loss		10,000
Sale price		10,000
Gain realized		

No change in the tax liability is authorized for taxable years preceding 1943 by reason of the difference between the $7,500 depreciation allowable and the $9,000 deduction previously allowed.

§ 1.373 Statutory provisions; loss not recognized in certain railroad reorganizations.

SEC. 373. *Loss not recognized in certain railroad reorganizations*—(a) *Nonrecognition of loss.* No loss shall be recognized if property of a railroad corporation, as defined in section 77 (m) of the Bankruptcy Act (49 Stat. 922; 11 U. S. C. 205), is transferred in pursuance of an order of the court having jurisdiction of such corporation—

(1) In a receivership proceeding, or

(2) In a proceeding under section 77 of the Bankruptcy Act,

to a railroad corporation (as defined in section 77 (m) of the Bankruptcy Act) organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding.

(b) *Basis.* (1) *Railroad corporations.* If the property of a railroad corporation (as defined in section 77 (m) of the Bankruptcy Act) was acquired after December 31, 1938, in pursuance of an order of the court having jurisdiction of such corporation—

(A) In a receivership proceeding, or

(B) In a proceeding under section 77 of the Bankruptcy Act,

and the acquiring corporation is a railroad corporation (as defined in section 77(m) of

the Bankruptcy Act) organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, the basis shall be the same as it would be in the hands of the railroad corporation whose property was so acquired.

(2) *Property acquired by street, suburban, or interurban electric railway corporation.* If the property of any street, suburban, or interurban electric railway corporation engaged as a common carrier in the transportation of persons or property in interstate commerce was acquired after December 31, 1934, in pursuance of an order of the court having jurisdiction of such corporation in a proceeding under section 77B of the Bankruptcy Act (48 Stat. 912), and the acquiring corporation is a street, suburban, or interurban electric railway engaged as a common carrier in the transportation of persons or property in interstate commerce, organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, then, notwithstanding the provisions of section 270 of the Bankruptcy Act (52 Stat. 904; 11 U. S. C. 670), the basis shall be the same as it would be in the hands of the corporation whose property was so acquired.

§ 1.373–1 Nonrecognition of loss upon transfer of property of railroad corporation.

(a) For the purpose of section 373 (a), it is unnecessary that the transfer be a direct transfer by the corporation undergoing reorganization or that such reorganization constitute a reorganization within the meaning of section 368 (a) since that section does not apply to part IV, subchapter C, chapter 1 of the Code. It is sufficient if the transfer is made in pursuance of an order of the court and is an integral step in the consummation of a plan of reorganization approved by the court having jurisdiction of the proceeding. If these conditions are satisfied, no loss is recognized to the transferor upon the ultimate transfer of the property, or to the transferor upon any intermediate transfer.

(b) Section 373 (a) applies only to a transfer resulting in a loss and has no application if the transfer therein described results in a gain.

(c) See section 354 (c) relative to exchanges by stock or security holders.

§ 1.373–2 Property acquired by railroad corporation in a receivership or railroad reorganization proceeding.

(a) Section 373(b)(1) sets forth certain conditions under which the basis of property acquired by a railroad corporation is the same as it would have been in the hands of the railroad corporation whose property was acquired. For the purpose of section 373(b)(1), it is unnecessary that the acquisition in question be a direct transfer from the corporation undergoing reorganization or that such reorganization constitute a reorganization within the meaning of section 368 (a) since that section does not apply to part IV, subchapter C, chapter 1 of the Code. It is sufficient if the acquisition is in pursuance of an order of the court and is an integral step in the consummation of a reorganization plan approved by the court having jurisdiction of the proceeding.

(b) If the conditions of section 373 (b) (1) are satisfied, then for the purpose of determining basis, the provisions of section 373 (b) (1) only shall apply, notwithstanding that the transaction might also fall within another basis provision.

§ 1.373–3 Property acquired by electric railway corporation in corporate reorganization proceeding.

Subject to the limitations and conditions set forth in section 373(b)(2), if the reorganization under section 77B of the Bankruptcy Act, 48 Stat. 912, of an electric railway corporation results in the acquisition of the property of such corporation by another corporate entity, the basis of such property in the hands of the acquiring corporation is the same as it would be in the hands of the old corporation. It is requisite to the application of the section that both corporations be street, suburban, or interurban electric railway corporations engaged in the transportation of persons or property in interstate commerce, and that the acquisition is in pursuance of an order of the court and is an integral step in the consummation of a reorganization plan approved by the court having jurisdiction of the proceeding. If section 373 (b) (2) applies, section 270 of the Bankruptcy Act (11 U. S. C. 670), relating to the adjustment of basis by reason of the cancellation or reduction of indebtedness in a corporate reorganization proceeding, is inapplicable. Moreover, if the transaction is within the provisions of section 373 (b) (2) and may also be considered to be within any other basis provision, then the provisions of section 373 (b) (2) only shall apply.

CARRYOVERS

§ 1.381(a) Statutory provisions; carryovers in certain corporate acquisitions; general rule.

SEC. 381. *Carryovers in certain corporate acquisitions*—(a) *General rule.* In the case of the acquisition of assets of a corporation by another corporation—

(1) In a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334 (b)(2); or

(2) In a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

§ 1.381(a)–1 General rule relating to carryovers in certain corporate acquisitions.

(a) *Allowance of carryovers.* Section 381 provides that a corporation which acquires the assets of another corporation in certain liquidations and reorganizations shall succeed to, and take into account, as of the close of the date of distribution or transfer, the items described in section 381(c) of the distributor or transferor corporation. These items shall be taken into account by the acquiring corporation subject to the conditions and limitations specified in sections 381 and 382(b) and the regulations thereunder.

(b) *Determination of transactions and items to which section 381 applies*—(1) *Qualified transactions.* Except to the extent provided in section 381(c)(20), relating to the carryover of unused pension trust deductions in certain liquidations, the items described in section 381(c) are required by section 381 to be carried over to the acquiring corporation (as defined in subparagraph (2) of this paragraph) only in the following liquidations and reorganizations:

(i) The complete liquidation of a subsidiary corporation upon which no gain or loss is recognized in accordance with the provisions of section 332, but only if the basis of the assets distributed to the acquiring corporation is not required by section 334(b)(2) to be the adjusted basis of the stock with respect to which the distribution is made;

(ii) A statutory merger or consolidation qualifying under section 368(a)(1)(A) to which section 361 applies;

(iii) A reorganization qualifying under section 368(a)(1)(C);

(iv) A reorganization qualifying under section 368(a)(1)(D) if the requirements of section 354(b)(1)(A) and (B) are satisfied; and

(v) A mere change in identity, form, or place of organization qualifying under section 368(a)(1)(F).

(2) *Acquiring corporation defined.* (i) Only a single corporation may be an acquiring corporation for purposes of section 381 and the regulations thereunder. The corporation which acquires the assets of its subsidiary corporation in a complete liquidation to which section 381(a)(1) applies is the acquiring corporation for purposes of section 381. Generally, in a transaction to which section 381(a)(2) applies, the acquiring corporation is that corporation which, pursuant to the plan of reorganization, ultimately acquires, directly or indirectly, all of the assets transferred by the transferor corporation. If, in a transaction qualifying under section 381(a)(2), no one corporation ultimately acquires all of the assets transferred by the transferor corporation, that corporation which directly acquires the assets so transferred shall be the acquiring corporation for purposes of section 381 and the regulations thereunder, even though such corporation ultimately retains none of the assets so transferred. Whether a corporation has acquired all of the assets transferred by the transferor corporation is a question of fact to be determined on the basis of all the facts and circumstances.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). Y Corporation, a wholly-owned subsidiary of X Corporation, directly acquired all the assets of Z Corporation solely in exchange for voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Y Corporation is the acquiring corporation for purposes of section 381.

Example (2). X Corporation acquired all the assets of Z Corporation solely in exchange for voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Thereafter, pursuant to the plan of reorganization X Corporation transferred all the assets so acquired to Y Corporation, its wholly-owned subsidiary (see section 368(a)(2)(C)). Y Corporation is the acquiring corporation for purposes of section 381.

Example (3). X Corporation acquired all the assets of Z corporation solely in exchange for the voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Thereafter, pursuant to the plan of reorganization X Corporation transferred one-half of the assets so acquired to Y Corporation, its wholly-owned subsidiary, and retained the other half of such assets. X Corporation is the acquiring corporation for purposes of section 381.

Example (4). X Corporation acquired all the assets of Z Corporation solely in exchange for voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Thereafter, pursuant to the plan of reorganization X Corporation transferred one-half of the assets so acquired to Y Corporation, its wholly-owned subsidiary, and the other half of such assets to M Corporation, another wholly-owned subsidiary of X Corporation. X Corporation is the acquiring corporation for purposes of section 381.

(3) *Transactions and items not covered by section 381.* (i) Section 381 does not apply to partial liquidations, divisive reorganizations, or other transactions not described in subparagraph (1) of this paragraph. Moreover, section 381 does not apply to the carryover of an item or tax attribute not specified in subsection (c) thereof. In a case where section 381 does not apply to a transaction, item, or tax attribute by reason of either of the preceding sentences, no inference is to be drawn from the provisions of section 381 as to whether any item or tax attribute shall be taken into account by the successor corporation.

(ii) If, pursuant to the provisions of subparagraph (2) of this paragraph, a corporation is considered to be the acquiring corporation even though a part of the acquired assets is transferred to one or more corporations controlled by the acquiring corporation, or all the acquired assets are transferred to two or more corporations controlled by the acquiring corporation, then the carryover of any item described in section 381(c) to such controlled corporation or corporations shall be determined without regard to section 381. Thus, for example, if a parent corporation is the acquiring corporation for purposes of section 381 notwithstanding the fact that, pursuant to the plan of reorganization, it transferred to its wholly-owned subsidiary property acquired from the transferor corporation which the transferor corporation had elected to inventory under the last-in first-out method, then the question whether the subsidiary corporation shall continue to use the same method of inventorying with respect to that property shall be determined without regard to section 381.

(c) *Foreign corporations.* A foreign corporation may be a distributor, transferor, or acquiring corporation for purposes of section 381. Thus, for example, the net operating loss carryovers of a foreign corporation, determined under the provisions of section 172 and subchapter N (section 861 and following), chapter 1 of the Code, may be carried over to a domestic acquiring corporation if the domestic corporation acquires the assets of the foreign corporation in a liquidation or reorganization described in section 381(a) and the requirements of § 1.367–1, if applicable, have been complied with.

(d) *Internal Revenue Code of 1939.* Any reference in the regulations under section 381 to any provision of the Internal Revenue Code of 1954 shall, where appropriate, be deemed also to refer to the corresponding provision of the Internal Revenue Code of 1939.

§ 1.381(b) Statutory provisions; carryovers in certain corporate acquisitions; operating rules.

SEC. 381. *Carryovers in certain corporate acquisitions.* * * *

(b) *Operating Rules.* Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1)—

(1) The taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer.

(2) For purposes of this section, the date of distribution or transfer shall be the day on which the distribution or transfer is completed; except that, under regulations prescribed by the Secretary or his delegate, the date when substantially all of the property has been distributed or transferred may be used if the distributor or transferor corporation ceases all operations, other than liquidating activities, after such date.

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

§ 1.381(b)–1 Operating rules applicable to carryovers in certain corporate acquisitions.

(a) *Closing of taxable year*—(1) *In general.* Except in the case of a reorganization qualifying under section 368(a)(1)(F), the taxable year of the distributor or transferor corporation shall end with the close of the date of distribution or transfer.

(2) *Reorganizations under section 368(a)(1)(F).* In the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the acquiring corporation shall be treated (for purposes of section 381) just as the transferor corporation would have been treated if there had been no reorganization. Thus, the taxable year of the transferor corporation shall not end on the date of transfer merely because of the transfer; a net operating loss of the acquiring corporation for any taxable year ending after the date of transfer shall be carried back in accordance with section 172(b) in computing the taxable income of the transferor corporation for a taxable year ending before the date of transfer; and the tax attributes of the transferor corporation enumerated in section 381(c) shall be taken into account by the acquiring corporation as if there had been no reorganization.

(b) *Date of distribution or transfer.* (1) The date of distribution or transfer shall be that day on which are distributed or transferred all those properties of the distributor or transferor corporation which are to be distributed or transferred pursuant to a liquidation or reorganization described in paragraph (b)(1) of § 1.381(a)–1. If the distribution or transfer of all such properties is not made on one day, then, except as provided in subparagraph (2) of this paragraph, the date of distribution or transfer shall be that day on which the distribution or transfer of all such properties is completed.

(2) If the distributor or transferor and acquiring corporations file the statements described in subparagraph (3) of this paragraph, the date of distribution or transfer shall be that day as of which (i) substantially all of the properties to be distributed or transferred have been distributed or transferred, and (ii) the distributor or transferor corporation has ceased all operations (other than liquidating activities). Such day also shall be the date of distribution or transfer if the completion of the distribution or transfer is unreasonably postponed beyond the date as of which substantially all the properties to be distributed or transferred have been distributed or transferred and the distributor or transferor corporation has ceased all operations other than liquidating activities. A corporation shall be considered to have distributed or transferred substantially all of its properties to be distributed or transferred even though it retains money or other property in a reasonable amount to pay outstanding debts or preserve the corporation's legal existence. A corporation shall be considered to have ceased all operations, other than liquidating activities, when it ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance of its money or other properties to its shareholders.

(3) The statements referred to in subparagraph (2) of this paragraph shall specify the day considered to be the date of distribution or transfer and shall specify, as of such date (i) the nature and amount of the total assets which were distributed or transferred and the dates so distributed or transferred, (ii) the nature and amount of the assets not distributed or transferred and the purpose for which they were retained, and (iii) the date on which the distributor or transferor corporation ceased all operations other than liquidating activities. Such statements shall be attached to the timely filed income tax return of the distributor or transferor corporation for its taxable year ending with such date of distribution or transfer and to the timely filed income tax return of the acquiring corporation for its first taxable year ending after such date, except that, with respect to any income tax return filed before October 11, 1960, any such statement shall be filed before October 11, 1960, with the district director with whom such return is filed.

(4) If—

(i) The last day of the acquiring corporation's taxable year is a Saturday, Sunday, or legal holiday, and

(ii) The day specified in subpargraph (1) or (2) of this paragraph as the date of distribution or transfer is the last business day before such Saturday, Sunday, or holiday,

then the last day of the acquiring corporation's taxable year shall be the date of distribution or transfer for purposes of section 381(b) and this section. For purposes of this subparagraph, the term "business day" means a day which is not a Saturday, Sunday, or legal holiday, and also means a Saturday, Sunday, or legal holiday if the date of distribution or transfer determined under subparagraph (1) or (2) of this paragraph is such Saturday, Sunday, or holiday.

(c) *Return of distributor or transferor corporation.* The distributor or transferor corporation shall file an income tax return for the taxable year ending with the date of distribution or transfer described in paragraph (b) of this section. If the distributor or transferor corporation remains in existence after such date of distribution or transfer, it shall file an income tax return for the taxable year beginning on the day following the date of distribution or transfer and ending with the date on which the distributor or transferor corporation's taxable year would have ended if there had been no distribution or transfer.

(d) *Carryback of net operating losses.* For provisions relating to the carryback of net operating losses of the acquiring corporation, see paragraph (b) of § 1.381(c)(1)–1.

§ 1.381(c)(1) Statutory provisions; carryovers in certain corporate acquisitions; items of the distributor or transferor corporation; net operating loss carryovers.

SEC. 381. *Carryovers in certain corporate acquisitions.* * * *

(c) *Items of the distributor or transferor corporation.* The items referred to in subsection (a) are:

(1) *Net operating loss carryovers.* The net operating loss carryovers determined under section 172, subject to the following conditions and limitations:

(A) The taxable year of the acquiring corporation to which the net operating loss carryovers of the distributor or transferor corporation are first carried shall be the first taxable year ending after the date of distribution or transfer.

(B) In determining the net operating loss deduction, the portion of such deduction attributable to the net operating loss carryovers of the distributor or transferor corporation to the first taxable year of the acquiring corporation ending after the date of distribution or transfer shall be limited to an amount which bears the same ratio to the taxable income (determined without regard to a net operating loss deduction) of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(C) For the purpose of determining the amount of the net operating loss carryovers under section 172(b)(2), a net operating loss for a taxable year (hereinafter in this subparagraph referred to as the "loss year") of a distributor or transferor corporation which ends on or before the end of a loss year of the acquiring corporation shall be considered to be a net operating loss for a year prior to such loss year of the acquiring corporation. For the same purpose, the taxable income for a "prior taxable year" (as the term is used in section 172(b)(2)) shall be computed as provided in such section; except that, if the date of distribution or transfer is on a day other than the last day of a taxable year of the acquiring corporation—

(i) Such taxable year shall (for the purpose of this subparagraph only) be considered to be 2 taxable years (hereinafter in this subparagraph referred to as the "pre-acquisition part year" and the "post-acquisition part year");

(ii) The pre-acquisition part year shall begin on the same day as such taxable year begins and shall end on the date of distribution or transfer;

(iii) The post-acquisition part year shall begin on the day following the date of distribution or transfer and shall end on the same day as the end of such taxable year;

(iv) The taxable income for such taxable year (computed with the modifications specified in section 172(b)(2)(A) but without a net operating loss deduction) shall be divided between the pre-acquisition part year and the post-acquisition part year in proportion to the number of days in each;

(v) The net operating loss deduction for the pre-acquisition part year shall be determined as provided in section 172(b)(2)(B), but without regard to a net operating loss year of the distributor or transferor corporation; and

(vi) The net operating loss deduction for the post-acquisition part year shall be determined as provided in section 172(b)(2)(B).

§ 1.381(c)(1)–1 Net operating loss carryovers in certain corporate acquisitions.

(a) *Carryover requirement.* (1) Section 381(c)(1) requires the acquiring corporation to succeed to, and take into account, the net operating loss carryovers of the distributor or transferor corporation. To determine the amount of these carryovers as of the close of the date of distribution or transfer, and to integrate them with any carryovers and carrybacks of the acquiring corporation for purposes of determining the taxable income of the acquiring corporation for taxable years ending after the date of distribution or transfer, it is necessary to apply the provisions of section 172 in accordance with the conditions and limitations of section 381(c)(1) and this section. See also section 382(b) and the regulations thereunder.

(2) The net operating loss carryovers and carrybacks of the acquiring corporation determined as of the close of the date of distribution or transfer shall be computed without reference to any net operating loss of a distributor or transferor corporation. The net operating loss carryovers of a distributor or transferor corporation as of the close of the date of distribution or transfer shall be determined without reference to any net operating loss of the acquiring corporation.

(b) *Carryback of net operating losses.* A net operating loss of the acquiring corporation for any taxable year ending after the date of distribution or transfer shall not be carried back in computing the taxable income of a distributor or transferor corporation. However, a net operating loss of the acquiring corporation for any such taxable year shall be carried back in accordance with section 172(b) in computing the taxable income of the acquiring corporation for a taxable year ending on or before the date of distribution or transfer. If a distributor or transferor corporation remains in existence after the date of distribution or transfer, a net operating loss sustained by it for any taxable year beginning after such date shall be carried back in accordance with section 172(b) in computing the taxable income of such corporation for a taxable year ending on or before that date, but may not be carried back or over in computing the taxable income of the acquiring corporation. This paragraph may be illustrated by the following examples:

Example (1). On December 31, 1954, X Corporation merged into Y Corporation in a statutory merger to which section 361 applies, and the charter of Y Corporation continued after the merger. Y Corporation sustained a net operating loss for the calendar year 1955. Y Corporation's net operating loss for 1955 may not be carried back in computing the taxable income of X Corporation but shall be carried back in computing the taxable income of Y Corporation.

Example (2). On December 31, 1954, X Corporation and Y Corporation transferred all their assets to Z Corporation in a statutory consolidation to which section 361 applies. Z Corporation sustained a net operating loss for the calendar year 1955. Z Corporation's net operating loss for 1955 may not be carried back in computing the taxable income of X Corporation or Y Corporation.

Example (3). On December 31, 1954, X Corporation ceased all operations (other than liquidating activities) and transferred substantially all its properties to Y Corporation in a reorganization qualifying under section 368(a)(1)(C). Such properties comprised all of X Corporation's properties which were to be transferred pursuant to the reorganization. In the process of liquidating its assets and winding up its affairs, X Corporation sustained a net operating loss for its taxable year beginning on January 1, 1955. This net operating loss of X Corporation shall be carried back in computing the taxable income of that corporation but may not be carried back or over in computing the taxable income of Y Corporation.

(c) *First taxable year to which carryovers apply.* (1) The net operating loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall first be carried to the first taxable year of the acquiring corporation ending after that date. This rule applies irrespective of whether the date of distribution or transfer is on the last day, or any other day, of the acquiring corporation's taxable year. Thus, such net operating loss carryovers shall first be used by the acquiring corporation with respect to the computation of its net operating loss deduction under section 172(a), and its taxable income determined under the provisions of section 172(b)(2), for such first taxable year. However, see paragraph (f) of this section.

(2) The net operating loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall be carried to the acquiring corporation without diminution by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation. Thus, if a parent corporation owning 80 percent of all classes of stock of its subsidiary corporation were to acquire its share of the assets of the subsidiary corporation upon a complete liquidation described in paragraph (b)(1)(i) of § 1.381(a)–1, then, subject to the conditions and limitations of this section, 100 percent of the net operating loss carryovers available to the subsidiary corporation as of the close of the date of distribution would be carried over to the parent corporation.

(d) *Limitation on net operating loss deduction for first taxable year ending after date of distribution or transfer.* (1) That part of the acquiring corporation's net operating loss deduction, determined in accordance with sections 172(a) and 381(c)(1), for its first taxable year ending after the date of distribution or transfer which is attributable to the net operating loss carryovers of the distributor or transferor corporation, is limited by section 381(c)(1)(B) and this paragraph to an amount equal to the acquiring corporation's postacquisition part year taxable income. Such postacquisition part year taxable income is the amount which bears the same ratio to the acquiring corporation's taxable income for the first taxable year ending after the date of distribution or transfer (determined under section 63 without regard to any net operating loss deduction but taking into account other items to which the acquiring corporation succeeds under section 381) as the number of days in such first taxable year which follow the date of distribution or transfer bears to the total number of days in such taxable year Thus, if the date of distribution or transfer is the last day of the acquiring corporation's taxable year, the net operating loss carryovers of the distributor or transferor are allowed in full in computing under section 172(a) the net operating loss deduction of the acquiring corporation for its first taxable year ending after that date. In such instance, the number of days in the first taxable year which follow the date of distribution or transfer is the total number of days in such taxable year.

(2) The limitation provided by section 381(c)(1)(B) applies solely for the purpose of computing the net operating loss deduction of the acquiring corporation under section 172(a) for the acquiring corporation's first taxable year ending after the date of distribution or transfer. The limitation does not apply for purposes of determining the portion of any net operating loss (whether of the distributor, transferor, or acquiring corporation) which may be carried to any taxable year of the acquiring corporation following its first taxable year ending after the date of distribution or transfer since such determination is made pursuant to section 172(b) and section 381(c)(1)(C). See paragraphs (e) and (f) of this section.

(3) The limitation provided by section 381(c)(1)(B) shall be applied to the aggregate of the allowable net operating loss carryovers of the distributor or transferor corporation without reference to the taxable years in which the net operating losses were sustained by such corporation. If the acquiring corporation has acquired the assets of two or more distributor or transferor corporations on the same date of distribution or transfer, then the limitation provided by section 381(c)(1)(B) shall be applied to the aggregate of the net operating loss carryovers from all of such distributor or transferor corporations.

(4) If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor or transferor corporations on two or more different dates of distribution or transfer within one taxable year of the acquiring corporation, the limitation to be applied under section 381(c)(1)(B) to the aggregate of such carryovers shall be governed by the rules prescribed in paragraph (b) of § 1.381(c)(1)–2.

(5) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example (1). (i) X Corporation and Y Corporation were organized on January 1, 1956, and make their returns on the calendar year basis. On December 16, 1957, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and taxable income (computed without the net operating loss deduction) of the two corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1956	($35,000)	($5,000)
Ending 12-16-57	(30,000)	xxx
1957	xxx	36,500

(ii) The aggregate of the net operating loss carryovers of X Corporation carried under section 381(c)(1)(A) to Y Corporation's taxable year ending December 31, 1957, is $65,000; but pursuant to section 381(c)(1)(B), only $1,500 of such aggregate amount ($36,500 × 15/365) may be used in computing the net operating loss deduction of Y Corporation for such taxable year under section 172(a). This limitation applies even though Y Corporation's own net operating loss carryover to such year is only $5,000, with the result that Y Corporation has taxable income under section 63 of $30,000 for its taxable year ending December 31, 1957, that is, $36,500 less the sum of $5,000 and $1,500.

(iii) For rules determining the portion of any given loss of X Corporation or Y Corporation which may be carried to a taxable year of Y Corporation following its taxable year ending December 31, 1957, see sections 172(b)(2) and 381(c)(1)(C) and paragraph (f) of this section.

Example (2). (i) X Corporation was organized on January 1, 1954, and Y Corporation was organized on January 1, 1956. Each corporation makes its return on the basis of the calendar year. On December 31, 1956, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income (computed without any net operating loss deduction) of the two corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1954	($5,000)	xxx
1955	(15,000)	xxx
1956	(10,000)	$20,000
1957	xxx	40,000

(ii) The aggregate of the net operating loss carryovers of X Corporation carried under section 381(c)(1)(A) to Y Corporation's taxable year 1957 is $30,000, and the full amount of such carryovers is allowed in such taxable year to Y Corporation as a deduction under section 172(a), since such amount does not exceed the limitation ($40,000 × 365/365) for such taxable year under section 381(c)(1)(B).

Example (3). (i) X Corporation, Y Corporation, and Z Corporation were organized on January 1, 1954, and each corporation makes its return on the basis of the calendar year. On September 30, 1956, X Corporation and Y Corporation transferred all their assets to Z Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income (computed without any net operating loss deduction) of the three corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (transferor)	Z Corporation (acquirer)
1954	($5,000)	($3,000)	($40,000)
1955	(4,000)	(2,000)	10,000
Ending 9-30-56	(1,000)	(9,000)	xxx
1956	xxx	xxx	73,200

(ii) The aggregate of the net operating loss carryovers of X Corporation and Y Corporation carried under section 381(c)(1)(A) to Z Corporation's taxable year 1956 is $24,000; but, pursuant to section 381(c)(1)(B), only $18,400 of such aggregate amount ($73,200 × 92/366) may be used in computing the net operating loss deduction of Z Corporation for such taxable year under section 172(a). For this purpose, Z Corporation may not use the total of the aggregate carryovers ($10,000) from X Corporation plus the aggregate carryovers ($14,000) from Y Corporation, even though each such aggregate of carryovers is separately less than the limitation ($18,400) applicable under section 381(c)(1)(B) and this section.

(iii) For rules determining the portion of any given loss of X Corporation, Y Corporation, or Z Corporation which may be carried to a taxable year of Z Corporation following its taxable year ending December 31, 1956, see sections 172(b)(2) and 381(c)(1)(C) and paragraph (f) of this section.

(e) *Computation of carryovers and carrybacks; general rule*—(1) *Sequence for applying losses and computation of taxable income.* The portion of any net operating loss which is carried back or carried over to any taxable year is the excess, if any, of the amount of the loss over the sum of the taxable income for each of the prior taxable years to which the loss may be carried under sections 172(b)(1) and 381. In determining the taxable income for each such prior taxable year for this purpose, the various

net operating loss carryovers and carrybacks to such prior taxable year are considered to be applied in reduction of the taxable income in the order of the taxable years in which the net operating losses are sustained, beginning with the loss for the earliest taxable year. The application of this rule to the taxable income of the acquiring corporation for any taxable year ending after the date of distribution or transfer involves the use of carryovers of the distributor or transfer corporation, and of carryovers and carrybacks of the acquiring corporation. In such instance, the sequence for the use of loss years remains the same, and the requirement is to begin with the net operating loss of the earliest taxable year, whether or not it is a loss of the distributor, transferor, or acquiring corporation. The taxable income of the acquiring corporation for any taxable year ending after the date of distribution or transfer shall be determined in the manner prescribed by section 172(b)(2), except that, if the date of distribution or transfer is on a day other than the last day of a taxable year of the acquiring corporation, the taxable income of such corporation for the taxable year which includes such date shall be computed in the special manner prescribed by section 381(c)(1)(C) and paragraph (f) of this section.

(2) *Loss year of transferor or distributor considered prior taxable year.* Section 381(c)(1)(C) provides that, for the purpose of determining the net operating loss carryovers under section 172(b)(2), a net operating loss for a loss year of a distributor or transferor corporation which ends on or before the last day of a loss year of the acquiring corporation shall be considered to be a net operating loss for a year prior to such loss year of the acquiring corporation. In a case where the acquiring corporation has acquired the assets of two or more distributor or transferor corporations on the same date of distribution or transfer, the loss years of the distributor or transferor corporations shall be taken into account in the order in which such loss years terminate; if any one of the loss years of a distributor or transferor corporation ends on the same day as the loss year of another distributor or transferor corporation, either loss year may be taken into account before the other.

(3) *Years to which losses may be carried.* The taxable years to which a net operating loss shall be carried back or carried over are prescribed by section 172(b)(1). Since the taxable year of the distributor or transferor corporation ends with the close of the date of distribution or transfer, such taxable year and the first taxable year of the acquiring corporation which ends after that date shall be considered two separate taxable years to which a net operating loss of the distributor or transferor corporation for any taxable year ending before that date may be carried over. This rule applies even though the taxable year of the distributor or transferor corporation which ends on the date of distribution or transfer is a period of less than twelve months. However, for the purpose of determining under section 172(b)(1) the taxable years to which a net operating loss of the acquiring corporation is carried over or carried back, the first taxable year of the acquiring corporation which ends after the date of distribution or transfer shall be treated as only one taxable year even though such taxable year is considered under section 381(c)(1)(C) and paragraph (f)(2) of this section as two taxable years. The application of this subparagraph may be illustrated by the following example:

Example. X Corporation was organized on January 1, 1954, and thereafter it sustained net operating losses in its calendar years 1954, 1955, and 1956. On June 30, 1957, X Corporation transferred all its assets to Y Corporation, which was organized on January 1, 1955, in a statutory merger to which section 361 applies. In its taxable year ending June 30, 1957, X Corporation sustained a net operating loss. Y Corporation sustained net operating losses in its calendar years 1955, 1956, and 1958, but had taxable income for the year 1957. The years to which these losses of X Corporation and Y Corporation shall be carried, and the sequence in which carried, are as follows:

Loss year	
X 1954	X 1955, X 1956, X 6/30/57, Y 1957, Y 1958.
X 1955	X 1954, X 1956, X 6/30/57, Y 1957, Y 1958, Y 1959.
Y 1955	Y 1956, Y 1957, Y 1958, Y 1959, Y 1960.
X 1956	X 1954, X 1955, X 6/30/57, Y 1957, Y 1958, Y 1959, Y 1960.
Y 1956	Y 1955, Y 1957, Y 1958, Y 1959, Y 1960, Y 1961.
X 6-30-57	X 1955, X 1956, Y 1957, Y 1958, Y 1959, Y 1960, Y 1961.
Y 1958	Y 1955, Y 1956, Y 1957, Y 1959, Y 1960, Y 1961, Y 1962, Y 1963.

(4) *Computation of carryovers in a case where the date of distribution or transfer occurs on last day of acquiring corporation's taxable year.* The computation of the net operating loss carryovers from the distributor or transferor corporation and from the acquiring corporation in a case where the date of distribution or transfer occurs on the last day of a taxable year of the acquiring corporation may be illustrated by the following example:

Example. X Corporation and Y Corporation were organized on January 1, 1955, and each corporation makes its return on the basis of the calendar year. On December 31, 1956, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income (computed without any net operating loss deduction) of the two corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1955	($2,000)	($11,000)
1956	(3,000)	10,000
1957	xxx	(15,000)

The sequence in which the losses of X Corporation and Y Corporation are applied, and the computation of the carryovers to Y Corporation's calendar year 1958, may be illustrated as follows:

(i) *X Corporation's 1955 loss.* The carryover to 1958 is $2,000, computed as follows:

Net operating loss		$2,000
Less:		
X's 1956 taxable income	$0	
Y's 1957 taxable income	0	
		0
Carryover		2,000

(ii) *Y Corporation's 1955 loss.* The carryover to 1958 is $1,000, computed as follows:

Net operating loss		$11,000
Less:		
Y's 1956 taxable income	$10,000	
Y's 1957 taxable income	0	
		10,000
Carryover		1,000

(iii) *X Corporation's 1956 loss.* The carryover to 1958 is $3,000, computed as follows:

Net operating loss		$3,000
Less:		
X's 1955 taxable income	$0	
Y's 1957 taxable income	0	
		0
Carryover		3,000

(iv) *Y Corporation's 1957 loss.* The carryover to 1958 is $15,000, computed as follows:

Net operating loss		$15,000
Less:		
Y's 1955 taxable income	$0	
Y's 1956 taxable income before net operating loss deduction	$10,000	
Minus Y's 1956 net operating loss deduction (i.e., Y's 1955 carryover)	11,000	
	0	
		0
Carryover		15,000

(v) *Summary of carryovers to 1958.* The aggregate of the net operating loss carryovers to 1958 is $21,000, computed as follows:

X's 1955 loss	$ 2,000
Y's 1955 loss	1,000
X's 1956 loss	3,000
Y's 1957 loss	15,000
Total	21,000

(f) *Computation of carryovers and carrybacks when date of distribution or transfer is not on last day of acquiring corporation's taxable year—(1) General rule.* Pursuant to the provisions of section 381(c)(1)(C), the taxable income of the acquiring corporation for its taxable year which is a prior taxable year for purposes of section 172(b)(2) and paragraph (e) of this section shall be determined in the manner prescribed in this paragraph, if the date of distribution or transfer occurs within, but not on the last day of, such taxable year.

(2) *Taxable year considered as two taxable years.* Such taxable year of the acquiring corporation shall be considered as though it were two taxable years, but only for the limited purpose of applying section 172(b)(2). The first of such two taxable years shall be referred to in this section as the preacquisition part year; the second, as the postacquisition part year. For purposes of section 172(b)(2), a net operating loss of the acquiring corporation shall be carried to the preacquisition part year and then to the postacquisition part year, whereas a net

operating loss of a distributor or transferor corporation shall be carried to the postacquisition part year and then to the acquiring corporation's subsequent taxable years. In determining under section 172(b)(2) and this paragraph the portion of any net operating loss of a distributor or transferor corporation which is carried to any taxable year of the acquiring corporation ending after the postacquisition part year, the taxable income (as determined under this paragraph) of the postacquisition part year shall be taken into account but the taxable income of the preacquisition part year (as so determined) shall not be taken into account. Though considered as two separate taxable years for purposes of section 172(b)(2), the preacquisition part year and the postacquisition part year are treated as one taxable year in determining the years to which a net operating loss is carried under section 172(b)(1). See paragraph (e)(3) of this section.

(3) *Preacquisition part year.* The preacquisition part year shall begin with the beginning of such taxable year of the acquiring corporation and shall end with the close of the date of distribution or transfer.

(4) *Postacquisition part year.* The postacquisition part year shall begin with the day following the date of distribution or transfer and shall end with the close of such taxable year of the acquiring corporation.

(5) *Division of taxable income.* The taxable income for such taxable year (computed with the modifications specified in section 172(b)(2)(A) but without any net operating loss deduction) of the acquiring corporation shall be divided between the preacquisition part year and the postacquisition part year in proportion to the number of days in each. Thus, if in a statutory merger to which section 361 applies Y Corporation acquires the assets of X Corporation on June 30, 1960, and Y Corporation has taxable income (computed in the manner so prescribed) of $36,600 for its calendar year 1960, then the preacquisition part year taxable income would be $18,200 ($36,600 × 182/366) and the postacquisition part year taxable income would be $18,400 ($36,600 × 184/366).

(6) *Net operating loss deduction.* After obtaining the taxable income of the preacquisition part year and of the postacquisition part year in the manner described in subparagraph (5) of this paragraph, it is necessary to compute the net operating loss deduction for each such part year. This deduction shall be determined in the manner prescribed by section 172(b)(2)(B) but subject to the provisions of this subparagraph. The net operating loss deduction for the preacquisition part year shall, for purposes of section 172(b)(2) only, be determined in the same manner as that prescribed by section 172(b)(2)(B) but shall be computed without taking into account any net operating loss of the distributor or transferor corporation. Therefore, only net operating loss carryovers and carrybacks of the acquiring corporation to the preacquisition part year shall be taken into account in computing the net operating loss deduction for such part year. The net operating loss deduction for the postacquisition part year shall, for purposes of section 172(b)(2) only, be determined in the same manner as that prescribed by section 172(b)(2)(B) and shall be computed by taking into account all the net operating loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer, as well as the net operating loss carryovers and carrybacks of the acquiring corporation to the postacquisition part year. The sequence in which the net operating losses of the two corporations shall be applied for purposes of this subparagraph shall be determined in the manner prescribed in paragraph (e) of this section.

(7) *Limitation on taxable income.* In no case shall the taxable income of the preacquisition part year or the postacquisition part year, as computed under this paragraph, be considered to be less than zero.

(8) *Cross reference.* If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer during the same taxable year of the acquiring corporation, the determination of the taxable income of the acquiring corporation for such year pursuant to section 381(c)(1)(C) shall be governed by the rules prescribed in paragraph (c) of § 1.381(c)(1)–2.

(9) *Illustration.* The application of this paragraph may be illustrated by the following example:

Example—(i) *Facts.* X Corporation was organized on January 1, 1955, and Y Corporation was organized on January 1, 1954. Each corporation makes its return on the basis of the calendar year. On June 30, 1956, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income (computed without any net operating loss deduction) of the two corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1954	xxx	($5,000)
1955	($65,000)	(20,000)
Ending 6-30-56	1,000	xxx
1956	xxx	36,600

(ii) *Y Corporation's 1954 loss.* The carryover to 1957 is $0, computed as follows:

Net operating loss		$5,000
Less:		
Y's 1955 taxable income		0
Carryover to Y's preacquisition part year		5,000
Less:		
Y's preacquisition part year taxable income computed under subparagraph (5) of this paragraph ($36,600 × 182/366)	$18,200	
Minus Y's net operating loss deduction for preacquisition part year	xxx	
		18,200
Carryover to Y's postacquisition part year and also to Y 1957		0

(iii) *X Corporation's 1955 loss.* The carryover to 1957 is $45,600, computed as follows:

Net operating loss		$65,000
Less:		
X's 6/30/56 year taxable income		1,000
Carryover to Y's postacquisition part year		64,000
Less:		
Y's postacquisition part year taxable income computed under subparagraph (5) of this paragraph ($36,600 × 184/366)	$18,400	
Less—Continued		
Minus Y's net operating loss deduction for postacquisition part year (i.e., Y's 1954 carryover of $0 to such part year)	0	
		$18,400
Carryover to Y 1957		45,600

(iv) *Y Corporation's 1955 loss.* The carryover to 1957 is $6,800, computed as follows:

Net operating loss		$20,000
Less:		
Y's 1954 taxable income		0
Carryover to Y's preacquisition part year		20,000
Less:		
Y's preacquisition part year taxable income computed under subparagraph (5) of this paragraph	$18,200	
Minus Y's net operating loss deduction for preacquisition part year (i.e., Y's 1954 carryover to such part year)	5,000	
		13,200
Carryover to Y's postacquisition part year		6,800
Less:		
Y's postacquisition part year taxable income computed under subparagraph (5) of this paragraph	$18,400	
Minus Y's net operating loss deduction for postacquisition part year (i.e., Y's 1954 carryover of $0, and X's 1955 carryover of $64,000, to such part year)	64,000	
		0
Carryover to Y 1957		6,800

(v) *Summary of carryovers to 1957.* The aggregate of the net operating loss carryovers to 1957 is $52,400, determined as follows:

Y's 1954 loss	$0
X's 1955 loss	45,600
Y's 1955 loss	6,800
Total	52,400

(g) *Successive acquiring corporations.* An acquiring corporation which, in a distribution or transfer to which section 381(a) applies, acquires the assets of a distributor or transferor corporation which previously acquired the assets of another corporation in a transaction to which section 381(a) applies, shall suc-

ceed to and take into account, subject to the conditions and limitations of sections 172 and 381, the net operating loss carryovers available to the first acquiring corporation under sections 172 and 381.

(h) *Illustration.* The application of this section may be further illustrated by the following example:

Example—(1) *Facts.* X Corporation was organized on January 1, 1954, and Y Corporation was organized on January 1, 1955. Each corporation makes its return on the basis of the calendar year. On August 31, 1957, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income of the two corporations for the taxable years involved are set forth in the tabulation below. The taxable income so shown is computed without the modifications required by section 172(b)(2)(A) and without the benefit of any net operating loss deduction. In its calendar year 1957, Y Corporation had a deduction of $365 which is disallowed by section 172(b)(2)(A).

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1954	($7,000)	xxx
1955	(10,000)	($10,000)
1956	(25,000)	(15,000)
Ending 8-31-57	1,000	xxx
1957	xxx	54,750
1958	xxx	(5,000)
1959	xxx	50,000

(2) *Computation of carryovers and carrybacks.* The sequence in which the losses of X Corporation and Y Corporation are applied and the computation of the carryovers to Y Corporation's calendar year 1959 may be illustrated as follows:

(i) *X Corporation's 1954 loss.* The carryover to 1958, which is the last year to which this loss may be carried, is $0, computed as follows:

Net operating loss		$7,000
Less:		
X's 1955 taxable income	$0	
X's 1956 taxable income	0	0
Carryover to X's 8/31/57-year		7,000
Less:		
X's 8/31/57-year taxable income		1,000
Carryover to Y's postacquisition part year		6,000
Less:		
Y's postacquisition part year taxable income computed under paragraph (f)(5) of this section (($54,750+$365)×122/365)		$18,422
Less—Continued		
Minus Y's net operating loss deduction for postacquisition part year	xxx	$18,422
Carryover to Y 1958		0

(ii) *X Corporation's 1955 loss.* The carryover to 1959 is $0, computed as follows:

Net operating loss		$10,000
Less:		
X's 1954 taxable income	$0	
X's 1956 taxable income	0	0
Carryover to X's 8/31/57-year		10,000
Less:		
X's 8/31/57-year taxable income before net operating loss deduction	$1,000	
Minus X's net operating loss deduction for 8/31/57-year (i.e., X's 1954 carryover)	7,000	0
Carryover to Y's postacquisition part year		10,000
Less:		
Y's postacquisition part year taxable income computed under paragraph (f)(5) of this section	$18,422	
Minus Y's net operating loss deduction for postacquisition part year (i.e., X's 1954 carryover to such part year)	6,000	12,422
Carryover to Y 1958 and Y 1959		0

(iii) *Y Corporation's 1955 loss.* The carryover to 1959 is $0, computed as follows:

Net operating loss		$10,000
Less:		
Y's 1956 taxable income		0
Carryover to Y's preacquisition part year		10,000
Less:		
Y's preacquisition part year taxable income computed under paragraph (f)(5) of this section (($54,750+$365)×243/365)		$36,693
Minus Y's net operating loss deduction for preacquisition part year	xxx	36,693
Carryover to Y's postacquisition part year, to Y 1958, and to Y 1959		0

(iv) *X Corporation's 1956 loss.* The carryover to 1959 is $22,578, computed as follows:

Net operating loss		$25,000
Less:		
X's 1954 taxable income	$0	
X's 1955 taxable income	0	
X's 8/31/57-year taxable income before net operating loss deduction	$1,000	
Minus X's net operating loss deduction for 8/31/57-year (i.e., X's 1954 carryover of $7,000 and X's 1955 carryover of $10,000)	$17,000	0
		0
Carryover to Y's postacquisition part year		25,000
Less:		
Y's postacquisition part year taxable income computed under paragraph (f)(5) of this section	$18,422	
Minus Y's net operating loss deduction for postacquisition part year (i.e., X's 1954 carryover of $6,000, X's 1955 carryover of $10,000 and Y's 1955 carryover of $0, to such part year)	16,000	2,422
Carryover to Y 1958		22,578
Less:		
Y's 1958 taxable income		0
Carryover to Y 1959		22,578

(v) *Y Corporation's 1956 loss.* The carryover to 1959 is $0, computed as follows:

Net operating loss		$15,000
Less:		
Y's 1955 taxable income		0
Carryover to Y's preacquisition part year		15,000
Less:		
Y's preacquisition part year taxable income computed under paragraph (f)(5) of this section	$36,693	
Minus Y's net operating loss deduction for preacquisition part year (i.e., Y's 1955 carryover to such part year)	10,000	26,693
Carryover to Y's postacquisition part year, to Y 1958, and to Y 1959		0

(vi) *Y Corporation's 1958 loss.* The carryover to 1959 is $0, computed as follows:

Net operating loss		$5,000
Less:		
Y's 1955 taxable income[1]	$0	
Y's 1956 taxable income	0	0
Carryback to Y's preacquisition part year		5,000
Less:		
Y's preacquisition part year taxable income computed under paragraph (f)(5) of this section	$36,693	
Minus Y's net operating loss deduction for preacquisition part year (i.e., Y's 1955 carryover of $10,000, and Y's 1956 carryover of $15,000, to such part year)	25,000	11,693
Carryback to Y's postacquisition part year and carryover to Y 1959		0

(vii) *Summary of carryovers to 1959.* The aggregate of the net operating loss carryovers to 1959 is $22,578, computed as follows:

X's 1955 loss	$0
Y's 1955 loss	0
X's 1956 loss	22,578
Y's 1956 loss	0
Y's 1958 loss	0
Total	22,578

(3) *Net operating loss deduction for 1957.* (i) The net operating loss deduction available to Y Corporation under section 172(a) for the calendar year 1957, determined in accordance with paragraph (d) of this section, is $48,300, computed as follows:

Aggregate of the net operating loss carryovers available to the transferor corporation as of the close of August 31, 1957, but limited by paragraph (d) of this section to $18,300 (Y's 1957 taxable income of $54,750, computed without any net operating loss deduction, multiplied by 122/365)		
Carryover of X's 1954 loss	$6,000	
Carryover of X's 1955 loss	10,000	
Carryover of X's 1956 loss	25,000	
	41,000	
Aggregate of carryovers, limited as above		$18,300
Carryover of Y's 1955 loss		10,000
Carryover of Y's 1956 loss		15,000
Carryback of Y's 1958 loss		5,000
Net operating loss deduction		48,300

[1] Three-year carryback in case of loss years ending after December 31, 1957.

(ii) The taxable income under section 63 for 1957 is $6,450, computed as follows:

Taxable income determined without any net operating loss deduction	$54,750
Less:	
Net operating loss deduction for 1957, as determined under subdivision (i) of this subparagraph	48,300
Taxable income under section 63	6,450

(4) *Net operating loss deduction for 1959.* The taxable income under section 63 for 1959 is $27,422, computed as follows:

Taxable income determined without any net operating loss deduction	$50,000
Less:	
Net operating loss deduction for 1959 (i.e., the aggregate carryovers determined under subparagraph (2)(vii) of this paragraph)	22,578
Taxable income under section 63	27,422

(5) *Years to which losses may be carried.* The taxable years to which the losses of X Corporation and Y Corporation may be carried, and the sequence in which carried, are as follows:

Loss year	*Carried to*
X 1954	X 1955, X 1956, X 8/31/57, Y 1957, Y 1958.
X 1955	X 1954, X 1956, X 8/31/57, Y 1957, Y 1958, Y 1959.
Y 1955	Y 1956, Y 1957, Y 1958, Y 1959, Y 1960.
X 1956	X 1954, X 1955, X 8/31/57, Y 1957, Y 1958, Y 1959, Y 1960.
Y 1956	Y 1955, Y 1957, Y 1958, Y 1959, Y 1960, Y 1961.
Y 1958	Y 1955, Y 1956, Y 1957, Y 1959, Y 1960, Y 1961, Y 1962, Y 1963.

§ 1.381(c)(1)–2 Net operating loss carryovers; two or more dates of distribution or transfer in the taxable year.

(a) *In general.* If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer within one taxable year of the acquiring corporation, the limitation to be applied under section 381(c)(1)(B) to the aggregate of the net operating loss carryovers to that taxable year from all of the distributor or transferor corporations shall be determined by applying the rules prescribed in paragraph (b) of this section, and the taxable income of the acquiring corporation for that taxable year under sections 381(c)(1)(C) and 172(b)(2) shall be determined by applying the rules prescribed in paragraph (c) of this section. For purposes of this section, the term "postacquisition income" means postacquisition part year taxable income determined under paragraph (d)(1) of § 1.381(c)(1)–1 by treating the first date of distribution or transfer as though it were the only date of distribution or transfer during the taxable year of the acquiring corporation.

(b) *Determination of limitation under section 381(c)(1)(B)—(1) In general.* If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer during the same taxable year of the acquiring corporation, and if the amount of the net operating loss carryovers acquired on the first date of distribution or transfer equals or exceeds the postacquisition income, then the limitation under section 381(c)(1)(B) shall be an amount equal to such postacquisition income. If the amount of the net operating loss carryovers acquired on the first date of distribution or transfer is less than such postacquisition income, then the limitation under section 381(c)(1)(B) shall be determined as provided in subparagraphs (2) through (5) of this paragraph.

(2) *Allocation of postacquisition income among partial postacquisition years.* That part of the taxable year of the acquiring corporation beginning on the day following the first date of distribution or transfer and ending with the close of the taxable year of the acquiring corporation shall be divided into the same number of partial postacquisition years as the number of dates of distribution or transfer on which the acquiring corporation succeeds to net operating loss carryovers during its taxable year. The first partial postacquisition year shall begin with the day following the first date of distribution or transfer and shall end with the close of the second date of distribution or transfer. The second and succeeding partial postacquisition years shall begin with the day following the close of the preceding such partial year and shall end with the close of the succeeding date of distribution or transfer, or, if there is no such succeeding date, then with the close of the taxable year of the acquiring corporation. The postacquisition income of the acquiring corporation shall be allocated among the partial postacquisition years in proportion to the number of days in each such partial year.

(3) *Two dates of distribution or transfer.* If the acquiring corporation succeeds to the net operating loss carryovers of two distributor or transferor corporations on two dates of distribution or transfer during the same taxable year of the acquiring corporation, and if the amount of the net operating loss carryovers acquired on the first date equals or exceeds the income for the first partial postacquisition year, the limitation provided by section 381(c)(1)(B) shall be the amount of the postacquisition income. If the income for the first partial postacquisition year exceeds the net operating loss carryovers acquired on the first date of distribution or transfer, the limitation provided by section 381(c)(1)(B) shall be the amount of the postacquisition income reduced by the amount of such excess. The application of this subparagraph may be illustrated by the following example:

Example. (i) X Corporation has taxable income (computed without any net operating loss deduction) of $36,500 for its calendar year 1955. During 1955, X Corporation acquires the assets of Y and Z Corporations in statutory mergers to each of which section 361 applies, the dates of transfer being January 1 and December 1, respectively. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corporation	Carryovers	Income for partial years	Reduction
Y	$1,000	$33,400 ($36,500 × 334/365)	$32,400
Z	50,000	3,000 ($36,500 × 30/365)	0
	51,000	36,400	32,400

(ii) The limitation provided by section 381(c)(1)(B) equals the postacquisition income of $36,400 reduced by $32,400, the excess of the income for the first partial year ($33,400) over the net operating loss carryovers acquired on the first date of transfer ($1,000). Accordingly, the limitation is $4,000 ($36,400 minus $32,400). Therefore, although X Corporation acquired carryovers aggregating $51,000 during 1955, it can utilize only $4,000 of such carryovers in computing its net operating loss deduction for 1955.

(4) *Three dates of distribution or transfer.* If the acquiring corporation succeeds to the net operating loss carryovers of three distributor or transferor corporations on three dates of distribution or transfer during the same taxable year of the acquiring corporation, and if the amount of the net operating loss carryovers acquired on the first date equals or exceeds the income for the first and second partial postacquisition years, the limitation provided by section 381(c)(1)(B) shall be the amount of the postacquisition income. If the amount of the carryovers acquired on the first date equals or exceeds the income for the first partial postacquisition year but does not equal or exceed the income for the first and second partial postacquisition years, the limitation shall be the amount of the postacquisition income reduced by the excess of the income for the first and second partial postacquisition years over the amount of carryovers acquired on the first and second dates of distribution or transfer. If the income for the first partial postacquisition year exceeds the carryovers acquired on the first date, the limitation shall be the postacquisition income reduced by the sum of the amount of such excess plus the amount, if any, by which the income for the second partial postacquisition year exceeds the carryovers acquired on the second date. This subparagraph may be illustrated by the following examples:

Example (1). (i) X Corporation has taxable income (computed without any net operating loss deduction) of $36,500 for its calendar year 1955. During 1955, X Corporation acquires the assets of M, N, and Z Corporations in statutory mergers to each of which section 361 applies, the dates of transfer being January 1, January 31, and December 1, respectively. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corporation	Carryovers	Income for partial years	Reduction
M	$4,000	$3,000 ($36,500× 30/365)	$23,400
N	6,000	30,400 ($36,500×304/365)	
Z	50,000	3,000 ($36,500× 30/365)	0
	60,000	36,400	23,400

(ii) Since the carryovers of $4,000 acquired on the first date of transfer exceed the income for the first partial year ($3,000), the limitation provided by section 381(c)(1)(B) is the amount of the postacquisition income ($36,400) reduced by the excess of the income for the first and second partial years

($33,400) over the carryovers acquired on the first and second dates of transfer ($10,000). Therefore, the limitation is $13,000 ($36,400 less $23,400).

Example (2). (i) Assume the same facts as in example (1) except that the amount of the net operating loss carryovers acquired from M Corporation is $1,000. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corporation	Carryovers	Income for partial years	Reduction
M	$1,000	$3,000 ($36,500×30/365)	$2,000
N	6,000	30,400 ($36,500×304/365)	24,400
Z	50,000	3,000 ($36,500×30/365)	0
	57,000	36,400	26,400

(ii) Since the income for the first partial year ($3,000) exceeds the $1,000 of carryovers acquired on the first date by $2,000, the limitation provided by section 381(c)(1)(B) is the postacquisition income of $36,400 reduced by such excess and also reduced by the excess of the income for the second partial year ($30,400) over the carryovers acquired on the second date of transfer ($6,000). Therefore, the limitation is $10,000 ($36,400 less the sum of $2,000 and $24,400).

Example (3). (i) Assume the same facts as in example (2) except that the carryovers acquired from N Corporation are $75,000. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corporation	Carryovers	Income for partial years	Reduction
M	$1,000	$3,000 ($36,500× 30/365)	$2,000
N	75,000	30,400 ($36,500×304/365)	0
Z	50,000	3,000 ($36,500× 30/365)	0
	126,000	36,400	2,000

(ii) Since the income for the first partial year ($3,000) exceeds the $1,000 of carryovers acquired on the first date by $2,000, the limitation provided by section 381(c)(1)(B) is the postacquisition income of $36,400 reduced by $2,000, or $34,400. No further reduction is made since the income for the second partial year ($30,400) does not exceed the carryovers of $75,000 acquired on the second date of transfer.

(5) *Four or more dates of distribution or transfer.* If the acquiring corporation succeeds to the net operating loss carryovers of four or more distributor or transferor corporations on four or more dates of distribution or transfer during the same taxable year of the acquiring corporation, the limitation provided by section 381(c)(1)(B) shall be determined consistently with the methods prescribed in subparagraphs (3) and (4) of this paragraph. The application of this subparagraph may be illustrated by the following example:

Example. (i) X Corporation has taxable income (computed without any net operating loss deduction) of $36,500 for its calendar year 1955. During 1955, X Corporation acquired the assets of M, N, O, Y, and Z Corporations in statutory mergers to each of which section 361 applied, the dates of transfer being, respectively, January 1, January 31, March 3, April 2, and December 1. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corporation	Carryovers	Income for partial years	Reduction
M	$1,000	$3,000 ($36,500× 30/365)	$2,000
N	4,000	3,100 ($36,500× 31/365)	1,100
O	1,000	3,000 ($36,500× 30/365)	
Y	10,000	24,300 ($36,500×243/365)	14,300
Z	20,000	3,000 ($36,500× 30/365)	0
	36,000	36,400	17,400

(ii) The limitation provided by section 381(c)(1)(B) equals the postacquisition income of $36,400 reduced by the sum of (*a*) the $2,000 excess of the income for the first partial year ($3,000) over the carryovers acquired from M Corporation ($1,000), (*b*) the $1,100 excess of the income for the second and third partial years ($6,100) over the carryovers acquired from N and O Corporations ($5,000), and (*c*) the $14,300 excess of the income for the fourth partial year ($24,300) over the carryovers acquired from Y Corporation ($10,000). Accordingly, the limitation is $19,000 ($36,400 minus $17,400). Therefore, although X Corporation acquired carryovers aggregating $36,000 during 1955, it can utilize only $19,000 of such carryovers in computing its net operating loss deduction for 1955.

(c) *Determination of taxable income of acquiring corporation under section 381(c)(1)(C)*—(1) *In general.* If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer within one taxable year of the acquiring corporation, then pursuant to section 381(c)(1)(C) the taxable income of the acquiring corporation for its taxable year which is a prior taxable year for purposes of section 172(b)(2) and paragraph (e) of § 1.381(c)(1)–1 shall be determined as provided in this paragraph.

(2) *Division of taxable income.* The taxable income of the acquiring corporation (computed with the modifications specified in section 172(b)(2)(A) but without any net operating loss deduction) shall be allocated proportionately on a daily basis among a preacquisition part year (determined under paragraph (f)(3) of § 1.381(c)(1)–1 by treating the first date of distribution or transfer as though it were the only date of distribution or transfer during the taxable year of the acquiring corporation) and two or more partial postacquisition years (determined as provided in paragraph (b)(2) of this section). The preacquisition part year and each partial postacquisition year shall be considered a separate taxable year, but only for the limited purpose of applying sections 172(b)(2) and 381(c)(1)(C).

(3) *Net operating loss deduction.* The net operating loss deduction of the preacquisition part year and the partial postacquisition years shall be determined consistently with the manner described in paragraph (f)(6) of § 1.381(c)(1)–1 but by taking into account, in the case of any partial postacquisition year, only the net operating loss carryovers and carrybacks of the acquiring corporation and those net operating loss carryovers from a distributor or transferor corporation which become available to the acquiring corporation as of the close of those dates of distribution or transfer which occur before the beginning of that specific partial postacquisition year. The sequence in which the net operating losses of the distributor or transferor and acquiring corporations shall be applied for this purpose shall be determined in the manner described in paragraph (e) of § 1.381(c)(1)–1. Subject to the preceding sentence, the net operating loss carryovers to any specific partial postacquisition year, whether from a distributor, transferor, or acquiring corporation, shall be taken into account in the order of the taxable years in which the net operating losses arose, beginning with the loss for the earliest taxable year.

(4) *Illustration.* The application of this paragraph may be illustrated by the following example:

Example—(i) *Facts.* X Corporation, which was organized on January 1, 1957, sustained a net operating loss of $20,000 for its calendar year 1957 and had taxable income (computed without any net operating loss deduction) of $36,500 for its calendar year 1958. During 1958, X Corporation acquired the assets of Y and Z Corporations in statutory mergers to each of which section 361 applied, the dates of transfer being June 30 and September 30, respectively. None of the modifications specified in section 172(b)(2)(A) apply to any of the corporations for any taxable year. The taxable income (computed without any net operating loss deduction) and net operating losses of Y and Z Corporations (which were organized on January 1, 1957, and January 1, 1954, respectively) are set forth below:

Taxable year	Acquiring corporation X	Transferor corporation Y	Transferor corporation Z
1954	xxx	xxx	($30,000)
1955	xxx	xxx	1,000
1956	xxx	xxx	1,000
1957	($20,000)	($25,000)	1,000
Ending 6–30–58	xxx	1,000	xxx
Ending 9–30–58	xxx	xxx	1,000
1958	36,500	xxx	xxx

The sequence in which the losses of the acquiring corporation and the transferor corporations are applied and the computation of the carryovers to X Corporation's calendar year 1959 are illustrated in the following subdivisions of this example.

(ii) *Computation of taxable income.* X Corporation's taxable income, determined in the manner described in subparagraph (2) of this paragraph, for the preacquisition part year and for the partial postacquisition years is as follows:

Year	Taxable income	Computation
Preacquisition part year	$18,100	$36,500×181/365
Partial No. 1	9,200	36,500× 92/365
Partial No. 2	9,200	36,500× 92/365

(iii) *Z Corporation's 1954 loss.* The carryover to 1959 is $0, computed as follows:

Net operating loss	$30,000
Less:	
Z's 1955, 1956, 1957, and 9/30/58-year income	4,000
Net operating loss carryover to Partial No. 2 year	26,000
Less:	
Partial No. 2 year taxable income	9,200
	16,800

The balance of $16,800 is not carried over to 1959 since X Corporation's taxable year 1958 is the last of the five years to which Z's 1954 loss may be carried under section 172(b)(1).

(iv) *Y Corporation's 1957 loss.* The carryover to 1959 is $14,800, computed as follows:

Net operating loss		$25,000
Less:		
Y's 6/30/58-year income	1,000	
Net operating loss carryover to Partial No. 1 year		24,000
Less:		
Partial No. 1 year taxable income	9,200	
Carryover to Partial No. 2 year		14,800
Less:		
X's Partial No. 2 year taxable income	$9,200	
Minus X's net operating loss deduction for Partial No. 2 year (i.e., Z's 1954 carryover of $26,000 to such partial year)	26,000	
		0
Carryover to 1959		14,800

(v) *X Corporation's 1957 loss.* The carryover to 1959 is $1,900, computed as follows:

Net operating loss		$20,000
Less:		
X's preacquisition part year taxable income	18,100	
Carryover to Partial No. 1 year		1,900
Less:		
Partial No. 1 year taxable income	$9,200	
Minus X's net operating loss deduction for Partial No. 1 year (i.e., Y's 1957 carryover of $24,000 to such partial year)	24,000	
		0
Carryover to Partial No. 2 year		1,900
Less:		
Partial No. 2 year taxable income	$9,200	
Minus X's net operating loss deduction for Partial No. 2 year (i.e., Z's 1954 carryover of $26,000, and Y's 1957 carryover of $14,800, to such partial year	40,800	
		0
Carryover to 1959		1,900

(vi) *Summary of carryovers to 1959.* The aggregate of the net operating loss carryovers to 1959 is $16,700, computed as follows:

Z's 1954 loss	xxx
Y's 1957 loss	$14,800
X's 1957 loss	1,900
Total	16,700

§ 1.382 [Reserved]

Effective Date of Subchapter C, Chapter 1 of the Code

§ 1.391 Statutory provisions; effective date of part I, subchapter C, chapter 1 of the Code.

Sec. 391. *Effective date of Part I.* Except as otherwise provided in this subchapter, part I shall take effect on June 22, 1954. Section 306 shall apply only with respect to dispositions (or redemptions) occurring on or after June 22, 1954.

§ 1.391–1 Effective date of part I of subchapter C.

Pursuant to section 395 and the regulations thereunder, the provisions of part I, subchapter C, chapter 1 of the Code, shall be effective with respect to the described transactions which occur on or after June 22, 1954, and with respect to section 306 (relating to the disposition or redemption of "section 306 stock"), such section shall apply only to stock which is received in a transaction subject to the Internal Revenue Code of 1954, and which is disposed of or redeemed after June 22, 1954. Generally, stock issued after June 22, 1954, will be section 306 stock if such stock comes within the definition set forth in section 306 (c). However, stock which otherwise qualifies within the definition set forth in section 306 is not section 306 stock if it is issued pursuant to a reorganization which by reason of the application of section 393 (b) and section 395 is governed by the provisions of the Internal Revenue Code of 1939 without amendment by the Internal Revenue Code of 1954. In addition, stock which otherwise qualifies within the definition set forth in section 306 (c) is not section 306 stock if it is issued pursuant to a reorganization which by reason of an election under section 393 (b) (2) is governed by the provisions of the Internal Revenue Code of 1939 without amendment by the Internal Revenue Code of 1954.

§ 1.392 Statutory provisions; effective date of part II, subchapter C, chapter 1 of the Code.

Sec. 392. *Effective date of Part II*—(a) *General rule.* Except as otherwise provided in this subchapter, part II shall apply with respect to a plan of liquidation only if the first distribution in pursuance of such plan occurs on or after June 22, 1954. Section 341 shall apply only with respect to sales, exchanges, and distributions on or after June 22, 1954.

(b) *Special rule for certain sales during 1954*—(1) *Nonrecognition of gain or loss.* If—

(A) All of the assets of a corporation (less assets retained to meet claims) are distributed before January 1, 1955, in complete liquidation of such corporation; and

(B) The corporation elects (at such time and in such manner as the Secretary or his delegate may by regulations prescribe) to have this subsection apply,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property during the calendar year 1954.

(2) *Certain provisions of section 337 made applicable.* For purposes of paragraph (1)—

(A) The term "property" has the meaning given to such term by section 337 (b); except that any determination required by section 337 (b) to be made by reference to the date of the adoption of the plan of liquidation shall be made by reference to January 1, 1954; and

(B) The limitations of section 337 (c) shall apply.

For purposes of section 453 (d) (4) (B) (relating to disposition of installment obligations), nonrecognition of gain or loss under paragraph (1) of this subsection shall be treated as nonrecognition of gain or loss under section 337.

(3) *Plans of liquidation adopted after December 31, 1953 and before June 22, 1954.* If the plan of complete liquidation was adopted after December 31, 1953, and before June 22, 1954, then, at the election of the corporation (made at such time and in such manner as the Secretary or his delegate may by regulations prescribe)—

(A) The 12-month period beginning on the date of the adoption of such plan shall be (i) the period for distribution (in lieu of the requirement in paragraph (1) (A) of this subsection that the assets be distributed before January 1, 1955), and (ii) the period during which, by reason of paragraph (1) of this subsection, gain or loss to the corporation is not recognized (in lieu of nonrecognition of gain or loss during the calendar year 1954); and

(B) Notwithstanding paragraph (2) (A) of this subsection, any determination required by section 337 (b) to be made by reference to the date of the adoption of the plan of liquidation shall be made by reference to such date (and not by reference to January 1, 1954).

§ 1.392–1 Effective date of part II of subchapter C.

(a) *General.* Section 392 provides the general rule that part II, subchapter C, chapter 1 of the Code, relating to liquidations shall be applicable only if the first distribution in pursuance of any plan of liquidation occurs on or after June 22, 1954. For this purpose, the date of adoption of the plan of liquidation is not material, except as provided in such part.

(b) *Certain sales in 1954.* Section 392 (b) provides special rules with respect to nonrecognition of gain or loss upon certain sales or exchanges of property in connection with liquidations completed during the calendar year 1954 and in connection with plans of liquidation adopted after December 31, 1953, and before June 22, 1954.

(c) *Election.* (1) Except as provided in subparagraph (2) of this paragraph, any election provided in section 392 (b) shall be made by attaching to the return of the liquidating corporation for the year in which falls the date of the final liquidating distribution, a statement indicating its election with respect to section 392 (b) or, in any case in which the final return of the corporation was filed on or before December 11, 1954, within 90 days after December 2, 1955, by filing such a statement with the proper district director of internal revenue for association with the final return.

(2) In any case in which the final return of a liquidating corporation was filed after December 11, 1954, and on or before December 2, 1955, any election provided in section 392 (b) shall be made either by attaching to the return of such corporation for the year in which falls the date of the final liquidating distribution, a statement indicating its election with respect to section 392 (b), or by filing such a statement on or before June 15, 1958, with the district director with whom such final return was filed.

(3) If a statement of election is not attached to the final return of a liquidating corporation or if such a statement is not filed with the proper district director within the time prescribed by this paragraph, the provisions of section 392 (b) shall not be applicable.

§ 1.393 Statutory provisions; effective dates of parts III and IV, subchapter C, chapter 1 of the Code.

Sec. 393. *Effective dates of Parts III and IV*—(a) *General rule.* Except as otherwise provided in this subchapter, parts III and IV shall take effect on June 22, 1954.

(b) *Special rules for plans of reorganization*—(1) *In general.* Except as provided in paragraphs (2) and (3), parts III and IV shall apply only in respect of plans of reorganization adopted on or after June 22, 1954. For purposes of this paragraph and paragraphs (2) and (3), a plan to make a trans-

fer to a controlled corporation described in section 351, or a plan to make an exchange or distribution which is described in section 355 (or so much of section 356 as relates to section 355) shall be treated as a plan of reorganization.

(2) *Election to have 1939 Code apply.* If—

(A) A plan of reorganization was submitted to the Secretary or his delegate before June 22, 1954, but such plan was not adopted before such date,

(B) The Secretary or his delegate issues (whether before, on, or after such date) a ruling with respect to such plan, and

(C) The corporations which are parties to the reorganization elect (at such time and in such manner as the Secretary or his delegate may by regulations prescribe) to have this paragraph apply,

then, if such reorganization is completed in accordance with the plan so submitted, the tax treatment of such reorganization (as to the corporations which are parties to the reorganization and as to their shareholders and security holders) shall be determined under the Internal Revenue Code of 1939 (in accordance with the contents of such ruling) and not under this Code.

(3) *Election to have 1954 Code apply.* If—

(A) A plan of reorganization—

(i) Was adopted after March 1, 1954, and before June 22, 1954, or

(ii) Was adopted before June 22, 1954, in pursuance of a court order and all distributions under the plan occur after March 1, 1954, and before July 1, 1954, and

(B) The corporations which are parties to the reorganization elect (at such time and in such manner as the Secretary or his delegate may by regulations prescribe) to have this paragraph apply,

then the tax treatment of such reorganization (as to the corporations which are parties to the reorganization and as to their shareholders and security holders) shall be determined under this Code and not under the Internal Revenue Code of 1939.

§ 1.393–1 Effective dates of parts III and IV of subchapter C.

Section 393 provides the general rule that part III (relating to corporate reorganizations) and part IV (relating to certain insolvency reorganizations), subchapter C, chapter 1 of the Code, shall take effect on June 22, 1954.

§ 1.393–2 Special rule with respect to certain plans of reorganization arising in 1954.

(a) For the purpose of section 393(b)(1)—

(1) If a corporation has adopted a plan of reorganization as there described before June 22, 1954, it may, if no action has been taken with respect to such plan which would constitute a realization of income or loss (whether or not recognized), and if no conveyance, exchange or distribution has been made by the corporation, rescind by proper corporate action and adopt such plan or another plan of reorganization after June 22, 1954, if all other corporations, parties to such reorganization, likewise rescind and readopt after such date.

(2) A corporation shall be considered to have adopted a plan of reorganization on the date on which a resolution of the board of directors is passed, adopting such plan or recommending its adoption to the shareholders, or upon the date of adoption of the plan of reorganization by the shareholders of such corporation, whichever is earlier.

(b) For the purpose of section 393 (b)(2)—

(1) A plan of reorganization shall be deemed to have been submitted before June 22, 1954, if such plan was filed before such date, with any office of the Internal Revenue Service with a request for a ruling as to the tax treatment thereof,

(2) A ruling with respect to such plan shall be a ruling letter signed by an official authorized to issue rulings in the office of the Assistant Commissioner (Technical) in the National Office of the Internal Revenue Service,

(3) Any such ruling issued shall be conclusive as to the law applicable to the transaction under the Internal Revenue Code of 1939 and for this purpose such Code shall be deemed not to be amended by the provisions of parts III and IV, subchapter C, chapter 1 of the Internal Revenue Code of 1954,

(4) A plan of reorganization shall be deemed to have been filed on the date it is placed in the mail as shown by the postmark on the envelope containing such request for ruling or as shown by other available evidence of the mailing date, if the envelope is properly addressed and the proper postage affixed.

(c) For the purpose of section 393 (b)(3), a plan of reorganization shall be considered to have been adopted by a corporation after March 1, 1954, and before June 22, 1954, if between such dates either the plan was adopted by the shareholders or a resolution of a board of directors was passed adopting the plan or recommending its adoption to the shareholders.

§ 1.393–3 Making and filing of elections.

The elections provided for in subsection (b) (2) and (b) (3) of section 393 shall be executed in the same manner as is required in the case of the income tax returns of the taxpayers. Where more than one corporation is involved in the transaction, all such corporations shall join in making the election, except that a corporation which was not in existence on June 22, 1954, shall not be required to make an election (unless it is the only corporation involved in the transaction). It will be sufficient if the corporations in existence on June 22, 1954, make the election for themselves and for the corporation to be organized after that date pursuant to the plan of reorganization, but such election shall be binding on the new corporation when it is formed and on the holders of its stock and securities. The elections are to be filed with the district director of internal revenue in the district in which the returns of the corporations are filed. The filing is to be accomplished by attaching the election (or certified copy thereof if more than one corporation is involved) to the tax return for the year in which the transaction took place. Furthermore, a copy of such election is to be attached to the income tax return of each shareholder or security holder who made exchanges, or received distributions, pursuant to the plan, for the year in which the transaction took place or, in any case in which the copy of the election is not received by such shareholder or security holder until after the due date for filing the return for the year in which the transaction took place, the copy of the election shall be filed with the proper district director of internal revenue for association with the return of such shareholder or security holder. The elections filed with the corporation returns must be accompanied by all relevant data pertaining to the transaction and by certified copies of the resolution of the directors authorizing the election. An election once made and filed by the corporations that are parties to the reorganization shall be irrevocable both as to the corporations involved and as to the holders of their stock and securities. Permanent records of all relevant data shall be kept by every taxpayer for whom an election was filed under section 393 (b), in order to facilitate the determination of gain or loss from a subsequent disposition of stock or securities or other property acquired in the transaction in respect of which the election was filed.

§ 1.394 [Reserved]

§ 1.395 Statutory provisions; special rules for application of subchapter C, chapter 1 of the Code.

SEC. 395. *Special rules for application of this subchapter*—(a) *Taxable years affected.* Any provision of this subchapter the applicability of which is stated in terms of a specific date shall apply with respect to taxable years ending after such date. Each provision shall, in the case of a taxable year subject to the Internal Revenue Code of 1939, be deemed to be included in the Internal Revenue Code of 1939, but shall apply only to taxable years ending after such specific date.

(b) *Repeal and continuance of Internal Revenue Code of 1939.* To the extent that the provisions of this subchapter supersede the provisions of the Internal Revenue Code of 1939, such provisions of the Internal Revenue Code of 1939 are hereby repealed. The provisions of the Internal Revenue Code of 1939 shall continue to apply with respect to transactions for which rules are provided in this subchapter until such rules take effect.

§ 1.395–1 Special rules for application of subchapter C.

(a) In general, under section 7851, the provisions of subchapter C, chapter 1 of the Code are applicable to any taxable year beginning after December 31, 1953, which ends after August 16, 1954, the date of the enactment of the Internal Revenue Code of 1954. The applicable date of each provision with respect to such year is stated either in connection therewith or in sections 391 through 394. The years to which this subchapter is applicable will include the calendar year 1954, and all fiscal years beginning in 1954 and ending after August 16, 1954. All years beginning before January 1, 1954, and ending either before, on or after August 16, 1954, are subject to the Internal Revenue Code of 1939. All taxable years beginning after December 31, 1953, and ending before August 16, 1954, are also subject to the Internal Revenue Code of 1939.

(b) If there is included in the return for a taxable year subject to the Internal Revenue Code of 1939 items to which the provisions of this subchapter would be applicable if such years were subject to the Internal Revenue Code of 1954, such

items shall be reported pursuant to the requirements of this subchapter if the transactions giving rise to such items occurred after the applicable dates specified. The determination in this case of the proper tax treatment shall be made by substituting the applicable provisions of subchapter C, chapter 1 of the Internal Revenue Code of 1954, for the provisions of the Internal Revenue Code of 1939 which would otherwise be applicable thereto. For example, if a complete liquidation of a corporation occurs and if such liquidation would have been subject to the provisions of section 332 had the Internal Revenue Code of 1954 been applicable then section 332 of this Code shall be deemed to have superseded section 112 (b) (6) of the Internal Revenue Code of 1939. If such transaction occurred prior to the applicable date, then the provisions of the Internal Revenue Code of 1939 alone are applicable. If there is included in the return for a taxable year subject to the Internal Revenue Code of 1954 items to which the provisions of this subchapter would be applicable, except for the applicable dates specified, such items shall be reported pursuant to the requirements of the Internal Revenue Code of 1939 applicable to such transactions. For example, the tax treatment of a complete liquidation of a corporation described in section 332 will be determined not by section 332 but pursuant to the rules of section 112 (b) (6) of the Internal Revenue Code of 1939. If such liquidation occurred after June 21, 1954, only section 332 shall be applicable.

DEFERRED COMPENSATION, ETC.

PENSION, PROFIT-SHARING, STOCK BONUS PLANS, ETC.

§ 1.401 Statutory provisions; qualified pension, profit-sharing, and stock bonus plans.

SEC. 401. *Qualified pension, profit-sharing, and stock bonus plans*—(a) *Requirements for qualification.* A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section—

(1) If contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404 (a) (3) (B) (relating to deduction for contributions to profit-sharing and stock bonus plans), for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) If under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries;

(3) If the trust, or two or more trusts, or the trust or trusts and annuity plan or plans are designated by the employer as constituting parts of a plan intended to qualify under this subsection which benefits either—

(A) 70 percent or more of all the employees, or 80 percent or more of all the employees who are eligible to benefit under the plan if 70 percent or more of all the employees are eligible to benefit under the plan, excluding in each case employees who have been employed not more than a minimum period prescribed by the plan, not exceeding 5 years, employees whose customary employment is for not more than 20 hours in any one week, and employees whose customary employment is for not more than 5 months in any calendar year, or

(B) Such employees as qualify under a classification set up by the employer and found by the Secretary or his delegate not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees;

and

(4) If the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

(5) A classification shall not be considered discriminatory within the meaning of paragraph (3) (B) or (4) merely because it excludes employees the whole of whose remuneration constitutes "wages" under section 3121 (a) (1) (relating to the Federal Insurance Contributions Act) or merely because it is limited to salaried or clerical employees. Neither shall a plan be considered discriminatory within the meaning of such provisions merely because the contributions or benefits of or on behalf of the employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees, or merely because the contributions or benefits based on that part of an employee's remuneration which is excluded from "wages" by section 3121 (a) (1) differ from the contributions or benefits based on employee's remuneration not so excluded, or differ because of any retirement benefits created under State or Federal law.

(6) A plan shall be considered as meeting the requirements of paragraph (3) during the whole of any taxable year of the plan if on one day in each quarter it satisfied such requirements.

(b) *Certain retroactive changes in plan.* A stock bonus, pension, profit-sharing, or annuity plan shall be considered as satisfying the requirements of paragraphs (3), (4), (5), and (6) of subsection (a) for the period beginning with the date on which it was put into effect and ending with the 15th day of the third month following the close of the taxable year of the employer in which the plan was put in effect, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period.

(c) *Cross reference.* For exemption from tax of a trust qualified under this section, see section 501 (a).

§ 1.401–1 Qualified pension, profit-sharing, and stock bonus plans.

(a) *Introduction.* (1) Sections 401 through 404 relate to pension, profit-sharing, stock bonus, and annuity plans, and compensation paid under a deferred-payment plan. Section 401(a) prescribes the requirements which must be met for qualification of a trust forming part of a pension, profit-sharing, or stock bonus plan.

(2) A qualified pension, profit-sharing, or stock bonus plan is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer—

(i) In the case of a pension plan, to provide for the livelihood of the employees or their beneficiaries after the retirement of such employees through the payment of benefits determined without regard to profits (see paragraph (b) (1) (i) of this section);

(ii) In the case of a profit-sharing plan, to enable employees or their beneficiaries to participate in the profits of the employer's trade or business, or in the profits of an affiliated employer who is entitled to deduct his contributions to the plan under section 404 (a) (3) (B), pursuant to a definite formula for allocating the contributions and for distributing the funds accumulated under the plan (see paragraph (b) (1) (ii) of this section); and

(iii) In the case of a stock bonus plan, to provide employees or their beneficiaries benefits similar to those of profit-sharing plans, except that such benefits are distributable in stock of the employer, and that the contributions by the employer are not necessarily dependent upon profits. If the employer's contributions are dependent upon profits, the plan may enable employees or their beneficiaries to participate not only in the profits of the employer, but also in the profits of an affiliated employer who is entitled to deduct his contributions to the plan under section 404 (a) (3) (B) (see paragraph (b) (1) (iii) of this section).

(3) In order for a trust forming part of a pension, profit-sharing, or stock bonus plan to constitute a qualified trust under section 401 (a), the following tests must be met:

(i) It must be created or organized in the United States, as defined in section 7701 (a) (9), and it must be maintained at all times as a domestic trust in the United States;

(ii) It must be part of a pension, profit-sharing, or stock bonus plan established by an employer for the exclusive benefit of his employees or their beneficiaries (see paragraph (b) (2) through (5) of this section);

(iii) It must be formed or availed of for the purpose of distributing to the employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with the plan;

(iv) It must be impossible under the trust instrument at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries (see § 1.401–2);

(v) It must be part of a plan which benefits prescribed percentages of the employees, or which benefits such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of certain specified classes of employees (see § 1.401–3); and

(vi) It must be part of a plan under which contributions or benefits do not discriminate in favor of certain specified classes of employees (see § 1.401–4).

(b) *General rules.* (1) (i) A pension plan within the meaning of section 401 (a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of section 401 (a), be considered a pension plan if the employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits, or, as in the case of money purchase pension plans, such contributions are fixed without being geared to profits. A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise. However, a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses.

(ii) A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. A formula for allocating the contributions among the participants is definite if, for example, it provides for an allocation in proportion to the basic compensation of each participant. A plan (whether or not it contains a definite predetermined formula for determining the profits to be shared with the employees) does not qualify under section 401 (a) if the contributions to the plan are made at such times or in such amounts that the plan in operation discriminates in favor of officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. For the rules with respect to discrimination, see §§ 1.401–3 and 1.401–4. A profit-sharing plan within the meaning of section 401 is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance.

(iii) A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. For the purpose of allocating and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, such a plan is subject to the same requirements as a profit-sharing plan.

(iv) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701 (a) (20).

(2) The term "plan" implies a permanent as distinguished from a temporary program. Thus, although the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. Especially will this be true if, for example, a pension plan is abandoned soon after pensions have been fully funded for persons in favor of whom discrimination is prohibited under section 401 (a). The permanency of the plan will be indicated by all of the surrounding facts and circumstances, including the likelihood of the employer's ability to continue contributions as provided under the plan. In the case of a profit-sharing plan, it is not necessary that the employer contribute every year or that he contribute the same amount or contribute in accordance with the same ratio every year. However, merely making a single or occasional contribution out of profits for employees does not establish a plan of profit-sharing. To be a profit-sharing plan, there must be recurring and substantial contributions out of profits for the employees. In the event a plan is abandoned, the employer should promptly notify the district director, stating the circumstances which led to the discontinuance of the plan.

(3) If the plan is so designed as to amount to a subterfuge for the distribution of profits to shareholders, it will not qualify as a plan for the exclusive benefit of employees even though other employees who are not shareholders are also included under the plan. The plan must benefit the employees in general, although it need not provide benefits for all of the employees. Among the employees to be benefited may be persons who are officers and shareholders. However, a plan is not for the exclusive benefit of employees in general if, by any device whatever, it discriminates either in eligibility requirements, contributions, or benefits in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees. See section 401 (a) (3), (4), and (5). Similarly, a stock bonus or profit-sharing plan is not a plan for the exclusive benefit of employees in general if the funds therein may be used to relieve the employer from contributing to a pension plan operating concurrently and covering the same employees. All of the surrounding and attendant circumstances and the details of the plan will be indicative of whether it is a bona fide stock bonus, pension, or profit-sharing plan for the exclusive benefit of employees in general. The law is concerned not only with the form of a plan but also with its effects in operation. For example, section 401 (a) (5) specifies certain provisions which of themselves are not discriminatory. However, this does not mean that a plan containing these provisions may not be discriminatory in actual operation.

(4) A plan is for the exclusive benefit of employees or their beneficiaries even though it may cover former employees as well as present employees and employees who are temporarily on leave, as, for example, in the Armed Forces of the United States. A plan covering only former employees may qualify under section 401 (a) if it complies with the provisions of section 401 (a) (3) (B), with respect to coverage, and section 401 (a) (4), with respect to contributions and benefits, as applied to all of the former employees. The term "beneficiaries" of an employee within the meaning of section 401 includes the estate of the employee, dependents of the employee, persons who are the natural objects of the employee's bounty, and any persons designated by the employee to share in the benefits of the plan after the death of the employee.

(5) (i) No specific limitations are provided in section 401 (a) with respect to investments which may be made by the trustees of a trust qualifying under section 401 (a). Generally, the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law. However, such a trust will be subject to tax under section 511 with respect to any "unrelated business taxable income" (as defined in section 512) realized by it from its investments. Furthermore, the tax-exempt status of the trust will be forfeited if the investments made by the trustees constitute "prohibited transactions" within the meaning of section 503. See also the regulations under such sections.

(ii) Where the trust funds are invested in stock or securities of, or loaned to, the employer or other person described in section 503 (c), full disclosure must be made of the reasons for such arrangement and the conditions under which such investments are made in order that a determination may be made whether the trust serves any purpose other than constituting part of a plan for the exclusive benefit of employees. The trustee shall report any of such investments on the return which under section 6033 it is required to file and shall with respect to any such investment furnish the information required by such return. See § 1.6033–1.

(c) *Portions of years.* A qualified status must be maintained throughout the entire taxable year of the trust in order for the trust to obtain any exemption for such year. But see section 401 (a) (6) and § 1.401–3.

(d) *Plan of several employers.* A trust forming part of a plan of several employers for their employees will be qualified if all the requirements are otherwise satisfied.

(e) *Determination of exemptions and returns.* (1) An employees' trust may request a determination letter as to its qualification under section 401 and exemption under section 501. For the procedure for obtaining such a determination letter see paragraph (l) of § 601.201 of this chapter (Statement of Procedural Rules).

(2) A trust which qualifies under section 401 (a) and which is exempt under section 501 (a) must file a return in accordance with section 6033 and the regulations thereunder. See § 1.6033–1. In case such a trust realizes any unrelated business taxable income, as defined in section 512, such trust is also required to file a return with respect to such income. See § 1.6012–3.

§ 1.401–2 Impossibility of diversion under the trust instrument.

(a) *In general.* (1) Under section 401(a)(2) a trust is not qualified unless under the trust instrument it is impossible (in the taxable year and at any time thereafter before the satisfaction of all liabilities to employees or their beneficiaries covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of such employees or their beneficiaries.

(2) As used in section 401 (a) (2), the phrase "if under the trust instrument it is impossible" means that the trust instrument must definitely and affirmatively make it impossible for the nonexempt diversion or use to occur, whether by operation or natural termination of the trust, by power of revocation or amendment, by the happening of a contingency, by collateral arrangement, or by any other means. Although it is not essential that the employer relinquish all power to modify or terminate the rights of certain employees covered by the trust, it must be impossible for the trust funds to be used or diverted for purposes other than for the exclusive benefit of his employees or their beneficiaries.

(3) As used in section 401 (a) (2), the phrase "purposes other than for the exclusive benefit of his employees or their beneficiaries" includes all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries covered by the trust.

(b) *Meaning of "liabilities".* (1) The intent and purpose in section 401 (a) (2) of the phrase "prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust" is to permit the employer to reserve the right to recover at the termination of the trust, and only at such termination, any balance remaining in the trust which is due to erroneous actuarial computations during the previous life of the trust. A balance due to an "erroneous actuarial computation" is the surplus arising because actual requirements differ from the expected requirements even though the latter were based upon previous actuarial valuations of liabilities or determinations of costs of providing pension benefits under the plan and were made by a person competent to make such determinations in accordance with reasonable assumptions as to mortality, interest, etc., and correct procedures relating to the method of funding. For example, a trust has accumulated assets of $1,000,000 at the time of liquidation, determined by acceptable actuarial procedures using reasonable assumptions as to interest, mortality, etc., as being necessary to provide the benefits in accordance with the provisions of the plan. Upon such liquidation it is found that $950,000 will satisfy all of the liabilities under the plan. The surplus of $50,000 arises, therefore, because of the difference between the amounts actuarially determined and the amounts actually required to satisfy the liabilities. This $50,000, therefore, is the amount which may be returned to the employer as the result of an erroneous actuarial computation. If, however, the surplus of $50,000 had been accumulated as a result of a change in the benefit provisions or in the eligibility requirements of the plan, the $50,000 could not revert to the employer because such surplus would not be the result of an erroneous actuarial computation.

(2) The term "liabilities" as used in section 401 (a) (2) includes both fixed and contingent obligations to employees. For example, if 1,000 employees are covered by a trust forming part of a pension plan, 300 of whom have satisfied all the requirements for a monthly pension, while the remaining 700 employees have not yet completed the required period of service, contingent obligations to such 700 employees have nevertheless arisen which constitute "liabilities" within the meaning of that term. It must be impossible for the employer (or other nonemployee) to recover any amounts other than such amounts as remain in the trust because of "erroneous actuarial computations" after the satisfaction of all fixed and contingent obligations. Furthermore, the trust instrument must contain a definite affirmative provision to this effect, irrespective of whether the obligations to employees have their source in the trust instrument itself, in the plan of which the trust forms a part, or in some collateral instrument or arrangement forming a part of such plan, and regardless of whether such obligations are, technically speaking, liabilities of the employer, of the trust, or of some other person forming a part of the plan or connected with it.

§ 1.401–3 Requirements as to coverage.

(a) (1) In order to insure that stock bonus, pension, and profit-sharing plans are utilized for the welfare of employees in general, and to prevent the trust device from being used for the principal benefit of shareholders, officers, persons whose principal duties consist in supervising the work of other employees, or highly paid employees, or as a means of tax avoidance, a trust will not be qualified unless it is part of a plan which satisfies the coverage requirements of section 401 (a) (3). The percentage requirements in section 401 (a) (3) (A) refer to a percentage of all the active employees, including employees temporarily on leave, such as those in the Armed Forces of the United States, if such employees are eligible under the plan.

(2) The application of section 401 (a) (3) (A) may be illustrated by the following example:

Example. An employer adopts a plan at a time when he has 1,000 employees. The plan provides that all full-time employees who have been employed by him for a period of two years and have reached the age of 30 shall be eligible to participate. The plan also requires participating employees to contribute 3 percent of their monthly pay. At the time the plan is made effective 100 of the 1,000 employees had not been employed for a period of two years. Fifty of the employees were seasonal employees whose customary employment did not exceed five months in any calendar year. Twenty-five of the employees were part-time employees whose customary employment did not exceed 20 hours in any one week. One hundred and fifty of the full-time employees who had been employed for two years or more had not yet reached age 30. The requirements of section 401 (a) (3) (A) will be met if 540 employees are covered by the plan, as shown by the following computation:

(i) Total employees with respect to whom the percentage requirements are applicable (1,000 minus 175 (100 plus 50 plus 25))	825
(ii) Employees not eligible to participate because of age requirements	150
(iii) Total employees eligible to participate	675
(iv) Percentage of employees in item (i) eligible to participate	81+%
(v) Minimum number of participating employees to qualify the plan (80 percent of 675)	540

If only 70 percent, or 578, of the 825 employees satisfied the age and service requirements, then 462 (80 percent of 578) participating employees would satisfy the percentage requirements.

(b) If a plan fails to qualify under the percentage requirements of section 401 (a) (3) (A), it may still qualify under section 401 (a) (3) (B) provided always that (as required by section 401 (a) (3) and (4)) the plan's eligibility conditions, benefits, and contributions do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees.

(c) Since, for the purpose of section 401, a profit-sharing plan is a plan which provides for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, layoff, or severance of employment, employees who receive the amounts allocated to their accounts before the expiration of such a period of time or the occurrence of such a contingency shall not be considered covered by a profit-sharing plan in determining whether the plan meets the coverage requirements of section 401 (a) (3) (A) and (B). Thus, in case a plan permits employees to receive immediately the amounts allocated to their accounts, or

to have such amounts paid to a profit-sharing plan for them, the employees who receive the shares immediately shall not, for the purpose of section 401, be considered covered by a profit-sharing plan.

(d) Section 401 (a) (5) sets out certain classifications that will not in themselves be considered discriminatory. However, those so designated are not intended to be exclusive. Thus, plans may qualify under section 401 (a) (3) (B) even though coverage thereunder is limited to employees who have either reached a designated age or have been employed for a designated number of years, or who are employed in certain designated departments or are in other classifications, provided the effect of covering only such employees does not discriminate in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees. For example, if there are 1,000 employees, and the plan is written for only salaried employees, and consequently only 500 employees are covered, that fact alone will not justify the conclusion that the plan does not meet the coverage requirements of section 401 (a) (3) (B). Conversely, if a contributory plan is offered to all of the employees but the contributions required of the employee participants are so burdensome as to make the plan acceptable only to the highly paid employees, the classification will be considered discriminatory in favor of such highly paid employees.

(e) (1) Section 401 (a) (5) contains a provision to the effect that a classification shall not be considered discriminatory within the meaning of section 401 (a) (3) (B) merely because all employees whose entire annual remuneration constitutes "wages" under section 3121 (a) (1) (for purposes of the Federal Insurance Contributions Act, chapter 21 of the Code) are excluded from the plan. A reference to section 3121(a) (1) for years after 1954 shall be deemed a reference to section 1426(a) (1) of the Internal Revenue Code of 1939 for years before 1955. This provision, in conjunction with section 401(a) (3) (B), is intended to permit the qualification of plans which supplement the old-age and survivor insurance benefits under the Social Security Act (42 U.S.C. ch. 7). Thus, a classification which excludes all employees whose entire remuneration constitutes "wages" under section 3121(a) (1), will not be considered discriminatory merely because of such exclusion. Similarly, a plan which includes all employees will not be considered discriminatory solely because the contributions or benefits based on that part of their remuneration which is excluded from wages under section 3121(a) (1) differ from the contributions or benefits based on that part of their remuneration which is not so excluded. However, in making his determination with respect to discrimination in classification under secton 401(a) (3) (B), the Commissioner will consider whether the total benefits resulting to each employee under the plan and under the Social Security Act, or under the Social Security Act only, establish an integrated and correlated retirement system satisfying the tests of section 401(a). If, therefore, a classification of employees under a plan results in relatively or proportionately greater benefits for employees earning above any specified salary amount or rate than for those below any such salary amount or rate, it may be found to be discriminatory within the meaning of section 401(a) (3) (B). If, however, the relative or proportionate differences in benefits which result from such classification are approximately offset by the old-age and survivors insurance benefits which are provided by the Social Security Act and which are not attributable to employee contributions under the Federal Insurance Contributions Act, the plan will be considered to be properly integrated with the Social Security Act and will, therefore, not be considered discriminatory.

(2) In determining whether a plan is properly integrated with the Social Security Act, the total old-age and survivor insurance benefits with respect to an employee are considered to be 150 percent of the employee's old-age insurance benefits under such Act, and the proportion of such total benefits which is attributable to employee contributions is considered to be approximately 22 percent of such total benefits. These assumptions take into consideration the changes made by the Social Security Amendments of 1958 (72 Stat. 1013). Thus, for example, a classification of employees under a noncontributory pension or annuity plan established in 1959 which is limited to employees earning in excess of $4,800 a year will not be considered discriminatory within the meaning of section 401 (a) (3) (B), if:

(i) Normal annual retirement benefits for any employee cannot exceed 37½ percent of his average annual compensation in excess of $4,800, where average annual compensation is defined to mean the average annual compensation over the highest five consecutive years.

(ii) There are no benefits payable in case of death before retirement.

(iii) The normal form of retirement benefit is a straight life annuity, and if there are optional forms, the benefit payments are adjusted so that the total value of the optional form is the same as the value of the normal form of retirement benefits.

(iv) Normal retirement benefits for employees who reach normal retirement age before completion of 15 years of service with the employer cannot exceed 2½% of average annual compensation in excess of $4,800 for each year of service.

(v) Normal retirement age is not lower than age 65 for men and not lower than age 60 for women.

(vi) Benefits payable in case of retirement or severance of employment before normal retirement age cannot exceed the actuarial equivalent of that proportion of the maximum normal retirement benefits, which might be provided in accordance with subdivisions (i) through (v) of this subparagraph, earned to the date of actual retirement or severance, where such proportion is determined by the ratio that the actual number of years of service of the employee at retirement or severance bears to the total number of years of service he would have had if he had remained in service until normal retirement age.

In the case of a plan limited to employees earning over $4,800 a year but providing different benefits, or providing benefits related to years of service, or providing benefits purchasable by stated employer contributions, or under which the employees contribute, or providing a combination of the foregoing variations, the plan will be considered to be properly integrated only if, as determined by the Commissioner, the benefits provided thereunder by employer contributions cannot exceed in value the benefits described in the example. Similar principles will govern in determining whether a plan is properly integrated if it is limited to employees whose compensation exceeds a stated level other than $4,800 a year, or if it bases benefits or contributions on compensation in excess of such a level, or if it provides for an offset of benefits otherwise payable under the plan on account of old-age and survivor insurance benefits. In the case of a profit-sharing or stock bonus plan which is limited to employees whose compensation is in excess of a stated level, or which bases contributions on compensation in excess of a stated level, similar principles will govern in determining whether the plan is discriminatory, provided that the employer does not also have in existence a pension or annuity plan which is integrated with old-age and survivor insurance benefits and which provides for employer contributions or benefits based upon all or part of the same compensation considered under the profit-sharing or stock bonus plan. In the case of a plan which is properly integrated with old-age and survivor insurance benefits as in effect before the Social Security Amendments of 1958 (72 Stat. 1013), and which is limited to employees earning in excess of a stated level, no adjustment is required merely because of the changes made by such Amendments.

(3) A plan supplementing the Social Security Act and excluding all employees whose entire annual remuneration constitutes "wages" under section 3121 (a) (1) will not, however, be deemed discriminatory merely because, for administrative convenience, it provides a reasonable minimum benefit not to exceed $20 a month.

(4) Similar considerations, to the extent applicable in any case, will govern classifications under a plan supplementing the benefits provided by other Federal or State laws. See section 401 (a) (5).

(f) An employer may designate several trusts or a trust or trusts and an annuity plan or plans as constituting one plan which is intended to qualify under section 401 (a) (3), in which case all of such trusts and plans taken as a whole may meet the requirements of such section. The fact that such combination of trusts and plans fails to qualify as one plan does not prevent such of the trusts and plans as qualify from meeting the requirements of section 401 (a).

(g) It is provided in section 401 (a) (6) that a plan will satisfy the requirements of section 401 (a) (3), if on at least one day in each quarter of the taxable year of the plan it satisfies such requirements. This makes it possible for a new plan requiring contributions from employees to qualify if by the end of the quarter-year in which the plan is adopted it secures sufficient contributing participants to meet the requirements of section 401 (a) (3). It also affords a period of time in which new participants may be secured to replace former participants, so as to meet the requirements of either subparagraph (A) or (B) of section 401 (a) (3).

§ 1.401–4 Discrimination as to contributions or benefits.

(a) (1) (i) In order to qualify under section 401(a), a trust must not only meet the coverage requirements of section 401(a)(3), but, as provided in section 401(a)(4), it must also be part of a plan under which there is no discrimination in contributions or benefits in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees as against other employees whether within or without the plan.

(ii) Since, for the purpose of section 401, a profit-sharing plan is a plan which provides for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, layoff, or severance of employment, any amount allocated to an employee which is withdrawn before the expiration of such a period of time or the occurrence of such a contingency shall not be considered in determining whether the contributions under the plan discriminate in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees. Thus, in case a plan permits employees to receive immediately the whole or any part of the amounts allocated to their accounts, or to have the whole or any part of such amounts paid to a profit-sharing plan for them, any amounts which are received immediately shall not, for the purpose of section 401, be considered contributed to a profit-sharing plan.

(iii) Funds in a stock bonus or profit-sharing plan arising from forfeitures on termination of service, or other reason, must not be allocated to the remaining participants in such a manner as will effect the prohibited discrimination. With respect to forfeitures in a pension plan, see paragraph (b) (1) (i) of § 1.401–1.

(2) (i) Section 401 (a) (5) sets out certain provisions which will not in and of themselves be discriminatory within the meaning of section 401 (a) (3) or (4). See § 1.401–3. Thus, a plan will not be considered discriminatory merely because the contributions or benefits bear a uniform relationship to total compensation or to the basic or regular rate of compensation, or merely because the contributions or benefits based on that part of the annual compensation of employees which is subject to the Federal Insurance Contributions Act (chapter 21 of the Code) differ from the contributions or benefits based on any excess of such annual compensation over such part.

(ii) The exceptions specified in section 401 (a) (5) are not an exclusive enumeration, but are merely a recital of provisions frequently encountered which will not of themselves constitute forbidden discrimination in contributions or benefits.

(iii) Variations in contributions or benefits may be provided so long as the plan, viewed as a whole for the benefit of employees in general, with all its attendant circumstances, does not discriminate in favor of employees within the enumerations with respect to which discrimination is prohibited. Thus, benefits in a stock bonus or profit-sharing plan which vary by reason of an allocation formula which takes into consideration years of service, or other factors, are not prohibited unless they discriminate in favor of such employees.

(b) A plan which excludes all employees whose entire remuneration constitutes wages under section 3121 (a) (1) (relating to the Federal Insurance Contributions Act), or a plan under which the contributions or benefits based on that part of an employee's remuneration which is excluded from "wages" under such act differs from the contributions or benefits based on that part of the employee's remuneration which is not so excluded, or a plan under which the contributions or benefits differ because of any retirement benefit created under State or Federal law, will not be discriminatory because of such exclusion or difference, provided the total benefits resulting under the plan and under such law establish an integrated and correlated retirement system satisfying the tests of section 401 (a).

(c) Although a plan may provide for termination at will by the employer, this will not of itself prevent a trust from being a qualified trust. However, in certain cases that fact may necessitate some provision in the plan which will preclude such termination from effecting the prohibited discrimination. This may occur where, for example, certain officers or highly compensated employees are at the inception of the plan within a few years of retirement age and the operation of the plan will fund and vest their benefits in a short period, thus resulting in such discrimination in favor of such officers or highly compensated employees.

§ 1.401–5 Period for which requirements of section 401 (a) (3), (4), (5), and (6) are applicable.

A pension, profit-sharing, stock bonus, or annuity plan shall be considered as satisfying the requirements of section 401(a) (3), (4), (5), and (6) for the period beginning with the date on which it was put into effect and ending with the 15th day of the third month following the close of the taxable year of the employer in which the plan was put into effect, if all the provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. Thus, if an employer in 1954 adopts such a plan as of January 1, 1954, and makes a return on the basis of the calendar year, he will have until March 15, 1955, to amend his plan so as to make it satisfy the requirements of section 401 (a) (3), (4), (5), and (6) for the calendar year 1954 provided that by March 15, 1955, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to January 1, 1954, the effective date of the plan. If an employer is on a fiscal year basis, for example, April 1 to March 31, and in 1954 adopts such a plan effective as of April 1, 1954, he will have until June 15, 1955, to amend his plan so as to make it satisfy the requirements of section 401 (a) (3), (4), (5), and (6) for the fiscal year beginning April 1, 1954, provided that by June 15, 1955, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to April 1, 1954, the effective date of the plan. It should be noted that under section 401 (b) the period in which a plan may be amended to qualify under section 401 (a) ends before the date on which taxpayers other than corporations are required to file income tax returns. See section 6072.

§ 1.402(a) Statutory provisions; taxability of beneficiary of employees' trust; exempt trust.

SEC. 402. *Taxability of beneficiary of employees' trust*—(a) *Taxability of beneficiary of exempt trust*—(1) *General rule.* Except as provided in paragraph (2), the amount actually distributed or made available to any distributee by any employees' trust described in section 401 (a) which is exempt from tax under section 501 (a) shall be taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities) except that section 72 (e) (3) shall not apply. The amount actually distributed or made available to any distributee shall not include net unrealized appreciation in securities of the employer corporation attributable to the amount contributed by the employee. Such net unrealized appreciation and the resulting adjustments to basis of such securities shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

(2) *Capital gains treatment for certain distributions.* In the case of an employees' trust described in section 401 (a), which is exempt from tax under section 501 (a), if the total distributions payable with respect to any employee are paid to the distributee within 1 taxable year of the distributee on account of the employee's death or other separation from the service, or on account of the death of the employee after his separation from the service, the amount of such distribution, to the extent exceeding the amounts contributed by the employee (determined by applying section 72 (f)), which employee contributions shall be reduced by any amounts theretofore distributed to him which were not includible in gross income, shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months. Where such total distributions include securities of the employer corporation, there shall be excluded from such excess the net unrealized appreciation attributable to that part of the total distributions which consists of the securities of the employer corporation so distributed. The amount of such net unrealized appreciation

and the resulting adjustments to basis of the securities of the employer corporation so distributed shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

(3) *Definitions.* For purposes of this subsection—

(A) The term "securities" means only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form.

(B) The term "securities of the employer corporation" includes securities of a parent or subsidiary corporation (as defined in section 421 (d) (2) and (3)) of the employer corporation.

(C) The term "total distributions payable" means the balance to the credit of an employee which becomes payable to a distributee on account of the employee's death or other separation from the service, or on account of his death after separation from the service.

§ 1.402(a)–1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).

(a) *In general.* (1) (i) Section 402 relates to the taxation of the beneficiary of an employees' trust. If an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust is exempt under section 501(a), the employee is not required to include such contribution in his income except for the year or years in which such contribution is distributed or made available to him. It is immaterial in the case of contributions to an exempt trust whether the employee's rights in the contributions to the trust are forfeitable or nonforfeitable either at the time the contribution is made to the trust or thereafter.

(ii) The provisions of section 402 (a) relate only to a distribution by a trust described in section 401 (a) which is exempt under section 501 (a) for the taxable year of the trust in which the distribution is made. The distribution from such an exempt trust when received or made available is taxable to the distributee to the extent provided in section 72 (relating to annuities), except that section 72(e)(3) (relating to the treatment of certain lump sums) shall not apply, and except that certain total distributions described in section 402(a)(2) are taxable as long-term capital gains. For the treatment of such total distributions, see subparagraph (6) of this paragraph. Under certain circumstances, an amount representing the unrealized appreciation in the value of the securities of the employer is excludable from gross income for the year of distribution. For the rules relating to such exclusion, see paragraph (b) of this section. Furthermore, the exclusion provided by section 105(d) is applicable to a distribution from a trust described in section 401(a) and exempt under section 501(a) if such distribution constitutes wages or payments in lieu of wages for a period during which an employee is absent from work on account of a personal injury or sickness. See § 1.72–15 for the rules relating to the tax treatment of accident or health benefits received under a plan to which section 72 applies.

(iii) Except as provided in paragraph (b) of this section, a distribution of property by a trust described in section 401 (a) and exempt under section 501 (a) shall be taken into account by the distributee at its fair market value. For example, where a United States savings bond which was purchased by a trustee in its own name later is distributed by such trust, it shall be taken into account at its redemption value at the time of distribution and such redemption value shall be the distributee's basis for the bond for the purpose of determining the extent to which income is realized upon its ultimate redemption.

(iv) If a trust is exempt for the taxable year in which the distribution occurs, but was not so exempt for one or more prior taxable years under section 501 (a) (or under section 165 (a) of the Internal Revenue Code of 1939 for years to which such section was applicable), the contributions of the employer which were includible in the gross income of the employee for the taxable year when made shall, in accordance with section 72 (f), also be treated as part of the consideration paid by the employee.

(v) If the trust is not exempt at the time the distribution is received by or made available to the employee, see section 402 (b) and paragraph (b) of § 1.402 (b)–1.

(2) If a trust described in section 401 (a) and exempt under section 501 (a) purchases an annuity contract for an employee and distributes it to the employee in a year for which the trust is exempt, the contract containing a cash surrender value which may be available to an employee by surrendering the contract, such cash surrender value will not be considered income to the employee unless and until the contract is surrendered. If, however, the contract distributed by such an exempt trust is a retirement income, endowment, or other life insurance contract and is distributed after October 26, 1956, the entire cash value of such contract at the time of distribution must be included in the distributee's income in accordance with the provisions of section 402 (a), except to the extent that, within 60 days after the distribution of such contract, all or any portion of such value is irrevocably converted into a contract under which no part of any proceeds payable on death at any time would be excludable under section 101 (a) (relating to life insurance proceeds).

(3) (i) If a trust described in section 401 (a) and exempt under section 501 (a) purchases under the plan retirement income, endowment, or other contracts providing life insurance protection, payable upon the death of the employee participants, and either—

(*a*) The proceeds of such life insurance are payable to a beneficiary of the employee participant, other than the trust, or

(*b*) In case such proceeds are payable to the trust, by the terms of the plan the trustee is required to pay over all of such proceeds to a beneficiary of the employee participant,

then, the portion of the premiums paid for the life insurance protection provided under such contracts from either the contributions of the employer or earnings of the trust will constitute income to the employee for the year or years in which the contributions or earnings are applied toward the purchase of such life insurance. If the amount payable upon death at any time during the year exceeds the cash value of the insurance policy at the end of the year, the entire amount of such excess will be considered current life insurance protection. The cost of such insurance will be considered to be a reasonable net premium cost, as determined by the Commissioner, for such amount for the appropriate period. The amount thus to be included in the gross income of the employee under this subdivision shall be considered as premiums or other consideration paid or contributed by the employee only with respect to any benefits attributable to the contract providing the life insurance protection.

(ii) The determination of the cost of life insurance protection may be illustrated by the following example:

Example. A policy purchased under a qualified plan for an employee provides an annuity of $100 per month upon retirement at age 65, with a minimum death benefit of $10,000. The insurance payable if death occurred in the first year would be $10,000. The cash value at the end of the first year is 0. The net insurance is therefore $10,000 minus 0, or $10,000. Assuming that the Commissioner has determined that a reasonable net premium for the employee's age is $5.85 per $1,000, the premium for $10,000 of life insurance is therefore $58.50, and this is the amount to be reported as income by the employee for the year. The balance of the premium is the amount contributed for the annuity, which is not taxable to the employee under a plan meeting the requirements of section 401 (a), except as provided under section 402 (a). Assuming that the cash value at the end of the second year is $500, the net insurance would then be $9,500 for the second year. With a net 1-year term rate of $6.30 for the employee's age in the second year, the amount to be reported as income to the employee would be $59.85.

(iii) This subparagraph shall not apply if the trust has a right under any circumstances to retain any part of the proceeds of the life insurance contract. But see subparagraph (4) (iv) of this paragraph relating to the taxability of the distribution of such proceeds to a beneficiary.

(4) (i) In case a trust described in section 401 (a) and exempt under section 501 (a) either—

(*a*) Has purchased a retirement income, endowment, or other life insurance contract, and the employee either paid the cost of the insurance or was taxable on the cost of the insurance under subparagraph (3) of this paragraph, or

(*b*) Has purchased an annuity contract, the amounts payable under any such contract by reason of the death of the employee are taxable under the rules of subdivision (ii) of this subparagraph, except in the case of a joint and survivor annuity.

(ii) (*a*) In the case of an annuity contract, the death benefit is the accumulation of the premiums (plus earnings thereon) which is intended to fund pension or other deferred benefits under

a pension or profit-sharing plan. Such death benefits are not in the nature of life insurance and are not excludable from gross income under section 101 (a).

(b) In the case of a retirement income, endowment, or other life insurance contract under which there is a reserve accumulation which is intended to fund pension or other deferred benefits under a pension or profit-sharing plan, such reserve accumulation constitutes the source of the cash value of the contract and approximates the amount of such cash value. The portion of the proceeds paid upon the death of the insured employee which is equal to the cash value immediately before death is not excludable from gross income under section 101 (a). The remaining portion, if any, of the proceeds paid to the beneficiary by reason of the death of the insured employee—that is, the amount in excess of the cash value—constitutes current insurance protection and is excludable under section 101 (a).

(c) The death benefit under an annuity contract, or the portion of the death proceeds under a retirement income, endowment, or other life insurance contract which is equal to the cash value of the contract immediately before death, constitutes a distribution from the trust consisting in whole or in part of deferred compensation and is taxable to the beneficiary in accordance with section 402 (a) and the provisions of this paragraph, except to the extent that the limited exclusion from income provided in section 101 (b) is applicable.

(d) In the case of a retirement income, endowment, or other life insurance contract under which the benefits are paid at a date or dates later than the death of the employee, section 101 (d) is applicable only to the portion of the benefits which is attributable to the amount excludable under section 101 (a). The portion of such benefits which is attributable to the cash value of the contract immediately before death is taxable under section 72 (relating to annuities), and in such case, any amount excludable under section 101 (b) is treated as additional consideration paid by the employee in accordance with section 101 (b) (2) (D).

(iii) The application of the rules under subdivision (ii) of this subparagraph with respect to the taxability of proceeds of a retirement income, endowment, or other life insurance contract paid by reason of the death of an insured employee who has paid no contributions under the plan is illustrated by the following examples:

Example (1).

Total face amount of the contract payable in a lump-sum at time of death	$25,000
Cash value of the contract immediately before death	11,000
Excess over cash value, excludable under section 101 (a)	14,000
Cash value subject to limited exclusion under section 101 (b)	$11,000
Excludable under section 101 (b) (assuming that there is no other death benefit paid by or on behalf of any employer with respect to the employee)	5,000
Balance taxable in accordance with section 402 (a) (2) (assuming a total distribution in one taxable year of the distributee)	6,000
Portion of premiums taxed to employee under the provisions of subparagraph (3) of this paragraph and considered as contributions of the employee	940
Balance taxable as long-term capital gain	5,060

Example (2). The facts are the same as in example (1), except that the contract provides that the beneficiary may elect within 60 days after the death of the employee either to take the $25,000 or to receive 10 annual installments of $3,000 each, and the beneficiary elects to receive the 10 installments. In addition, the employee's rights to the cash value immediately before his death were forfeitable at least to the extent of $5,000. Section 101 (d) is applicable to the amount excludable under section 101 (a), that is, $14,000. The portion of each annual installment of $3,000 which is attributable to this $14,000 is determined by allocating each installment in accordance with the ratio which this $14,000 bears to the total amount which was payable at death ($25,000). Accordingly, the portion of each annual installment which is subject to section 101 (d) is $1,680 (14/25 of $3,000), of which, $1,400 (1/10 of $14,000) is excludable under section 101 (a), and the remaining $280 is includible in the gross income of the beneficiary. However, if the beneficiary is a surviving spouse as defined in section 101 (d) (3), the exclusion provided by section 101 (d) (1) (B) is applicable to such $280. The remaining portion of each annual $3,000 installment, $1,320, is attributable to the cash value of the contract and is treated under section 72, as follows:

Amount actually contributed by the employee	$00
Amount considered contributed by employee by reason of section 101 (b)	5,000
Portion of premiums taxed to employee under the provisions of subparagraph (3) of this paragraph and considered as contributions of the employee	940
Investment in the contract	5,940
Expected return, 10×$1,320	13,200
Exclusion ratio, $5,940÷$13,200	.45
Annual exclusion, .45×$1,320	594

Accordingly, $594 of the $1,320 portion of each annual installment is excludable each year under section 72, and the remaining $726 is includible. Thus, if the beneficiary is not a surviving spouse, a total of $1,006 ($280 plus $726) of each annual $3,000 installment is includible in income each year. If the beneficiary is a surviving spouse, and can exclude all of the $280 under section 101 (d) (1) (B), the amount includible in gross income each year is $726 of each annual $3,000 installment.

(iv) If an employee neither paid the total cost of the life insurance protection provided under a retirement income, endowment, or other life insurance contract, nor was taxable under subparagraph (3) of this paragraph with respect thereto, no part of the proceeds of such a contract which are paid to the beneficiaries of the employee as a death benefit is excludable under section 101 (a). The entire distribution is taxable to the beneficiaries under section 402 (a) except to the extent that a limited exclusion may be allowable under section 101 (b).

(5) If pension or annuity payments or other benefits are paid or made available to the beneficiary of a deceased employee or a deceased retired employee by a trust described in section 401 (a) which is exempt under section 501 (a), such amounts are taxable in accordance with the rules of section 402 (a) and this section. In case such amounts are taxable under section 72, the "investment in the contract" shall be determined by reference to the amount contributed by the employee and by applying the rules of sections 72 (c), 72 (f), 101 (b) (2) (D), and subparagraph (3) of this paragraph. In case the amounts paid to, or includible in the gross income of, the beneficiaries of the deceased employee or deceased retired employee constitute a distribution to which subparagraph (6) of this paragraph is applicable, the extent to which the distribution is taxable is determined by reference to the contributions of the employee, by reference to any prior distributions which were excludable from gross income as a return of employee contributions, and by applying the rules of sections 72 (f), 101 (b), and subparagraph (3) of this paragraph.

(6) (i) If the total distributions payable with respect to any employee under a trust described in section 401 (a) which in the year of distribution is exempt under section 501 (a) are paid to, or includible in the gross income of, the distributee within one taxable year of the distributee on account of the employee's death or other separation from the service, or death after such separation from service, the amount of such distribution, to the extent it exceeds the net amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. The total distributions payable are includible in the gross income of the distributee within one taxable year if they are made available to such distributee and the distributee fails to make a timely election under section 72 (h) to receive an annuity in lieu of such total distributions. For rules relating to the treatment of such total distributions in the case of a nonresident alien individual, see sections 871 and 1441 and the regulations thereunder. The "net amount contributed by the employee" is the amount actually contributed by the employee plus any amounts considered to be contributed by the employee under the rules of sections 72 (f), 101 (b), and subparagraph (3) of this paragraph, reduced by any amounts theretofore distributed to him which were excludable from gross income as a return of employee contributions. See, however, paragraph (b) of this section for rules relating to the exclusion of amounts representing net unrealized appreciation in the value of securities of the employer corporation.

(ii) The term "total distributions payable" means the balance to the credit of an employee which becomes payable to a distributee on account of the employee's death or other separation from the service or on account of his death after separation from the service. Thus, distributions made before a total distribution (for example, annuity payments received by the employee after re-

tirement), will not defeat application of the capital gains treatment with respect to the total distributions received by a beneficiary upon the death of the employee after retirement. However, a distribution on separation from service will not receive capital gains treatment unless it constitutes the total amount in the employee's account at the time of his separation from service. If the total amount in the employee's account at the time of his death or other separation from the service or death after separation from the service is paid or includible in the gross income of the distributee within one taxable year of the distributee, such amount is entitled to the capital gains treatment notwithstanding that in a later taxable year an additional amount, attributable to the last year of service, is credited to the account of the employee and distributed.

(iii) If an employee retires and commences to receive an annuity but subsequently, in some succeeding taxable year, is paid a lump sum in settlement of all future annuity payments, the capital gains treatment does not apply to such lump sum settlement paid during the lifetime of the employee since it is not a payment on account of separation from the service, or death after separation, but is on account of the settlement of future annuity payments.

(iv) If the "total distributions payable" are paid or includible in the gross income of several distributees within one taxable year on account of the employee's death or other separation from the service or on account of his death after separation from the service, the capital gains treatment is applicable. The total distributions payable are paid within one taxable year of the distributees when, for example, a portion of such total is distributed in cash to one distributee and the balance is used to purchase an annuity contract which is distributed to the other distributee. However, if the share of any distributee is not paid or includible in his gross income within the same taxable year in which the shares of the other distributees are paid or includible in their gross income, none of the distributees is entitled to the capital gains treatment, since the total distributions payable are not paid or includible in the distributees' gross income within one taxable year. For example, if the total distributions payable are made available to each of two distributees and one elects to receive his share in cash while the other makes a timely election under section 72 (h) to receive his share in installment payments from the trust, the capital gains treatment does not apply to either distributee.

(v) For regulations as to certain plan terminations, see § 1.402 (e)–1.

(b) *Distributions including securities of the employer corporation*—(1) *In general.* (i) If a trust described in section 401 (a) which is exempt under section 501 (a) makes a distribution to a distributee, and such distribution includes securities of the employer corporation, the amount of any net unrealized appreciation in such securities shall be excluded from the distributee's income in the year of such distribution to the following extent:

(*a*) If the distribution constitutes a total distribution to which the regulations of paragraph (a) (6) of this section are applicable, the amount to be excluded is the entire net unrealized appreciation attributable to that part of the total distribution which consists of securities of the employer corporation; and

(*b*) If the distribution is other than a total distribution to which paragraph (a) (6) of this section is applicable, the amount to be excluded is that portion of the net unrealized appreciation in the securities of the employer corporation which is attributable to the amount considered to be contributed by the employee to the purchase of such securities.

The amount of net unrealized appreciation which is excludable under the regulations of (*a*) and (*b*) of this subdivision shall not be included in the basis of the securities in the hands of the distributee at the time of distribution for purposes of determining gain or loss on their subsequent disposition. In the case of a total distribution the amount of net unrealized appreciation which is not included in the basis of the securities in the hands of the distributee at the time of distribution shall be considered as a gain from the sale or exchange of a capital asset held for more than six months to the extent that such appreciation is realized in a subsequent taxable transaction. However, if the net gain realized by the distributee in a subsequent taxable transaction exceeds the amount of the net unrealized appreciation at the time of distribution, such excess shall constitute a long-term or short-term capital gain depending upon the holding period of the securities in the hands of the distributee.

(ii) For purposes of section 402 (a) and of this section, the term "securities" means only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form, and the term "securities of the employer corporation" includes securities of a parent or subsidiary corporation (as defined in section 421 (d) (2) and (3), relating to employee stock options) of the employer corporation.

(2) *Determination of net unrealized appreciation.* (i) The amount of net unrealized appreciation in securities of the employer corporation which are distributed by the trust is the excess of the market value of such securities at the time of distribution over the cost or other basis of such securities to the trust. Thus, if a distribution consists in part of securities which have appreciated in value and in part of securities which have depreciated in value, the net unrealized appreciation shall be considered to consist of the net increase in value of all of the securities included in the distribution. For this purpose, two or more distributions made by a trust to a distributee in a single taxable year of the distributee shall be treated as a single distribution.

(ii) For the purpose of determining the net unrealized appreciation on a distributed security of the employer corporation, the cost or other basis of such security to the trust shall be computed in accordance with whichever of the following rules is applicable:

(*a*) If a security was earmarked for the account of a particular employee at the time it was purchased by or contributed to the trust so that the cost or other basis of such security to the trust is reflected in the account of such employee, such cost or other basis shall be used.

(*b*) If as of the close of each taxable year of the trust (or other specified period of time not in excess of 12 consecutive calendar months) the trust allocates among the accounts of participating employees all securities acquired by the trust during the period (exclusive of securities unallocated under a plan providing for allocation in whole shares only), the cost or other basis to the trust of any securities allocated as of the close of a particular allocation period shall be the average cost or other basis to the trust of all securities of the same type which were purchased or otherwise acquired by the trust during such allocation period. For purposes of determining the average cost to the trust of securities included in a subsequent allocation, the actual cost to the trust of the securities unallocated as of the close of a prior allocation period shall be deemed to be the average cost or other basis to the trust of securities of the same type allocated as of the close of such prior allocation period.

(*c*) In a case where neither (*a*) nor (*b*) of this subdivision is applicable, if the trust fund, or a specified portion thereof, is invested exclusively in one particular type of security of the employer corporation, and if during the period the distributee participated in the plan none of such securities has been sold except for the purpose of paying benefits under the trust or for the purpose of enabling the trustee to obtain funds with which to exercise rights which have accrued to the trust, the cost or other basis to the trust of all securities distributed to such distributee shall be the total amount credited to the account of such distributee (or such portion thereof as was available for investment in such securities) reduced by the amount available for investment but uninvested on the date of distribution. If at the time of distribution to a particular distributee a portion of the amount credited to his account is forfeited, appropriate adjustment shall be made with respect thereto in determining the cost or other basis to the trust of the securities distributed.

(*d*) (*1*) In all other cases, there shall be used the average cost (or other basis) to the trust of all securities of the employer corporation of the type distributed to the distributee which the trust has on hand at the time of the distribution, or which the trust had on hand on a specified inventory date which date does not precede the date of distribution by more than twelve calendar months. If a distribution includes securities of the em-

ployer corporation of more than one type, the average cost (or other basis) to the trust of each type of security distributed shall be determined. The average cost to the trust of securities of the employer corporation on hand on a specified inventory date (or on hand at the time of distribution) shall be computed on the basis of their actual cost, considering the securities most recently purchased to be those on hand, or by means of a moving average calculated by subtracting from the total cost of securities on hand immediately preceding a particular sale or distribution an amount computed by multiplying the number of securities sold or distributed by the average cost of all securities on hand preceding such sale or distribution.

(2) These methods of computing average cost may be illustrated by the following examples:

Example (1). A, a distributee who makes his income tax returns on the basis of a calendar year, receives on August 1, 1954, in a total distribution, to which paragraph (a) (6) of this section is applicable, ten shares of class D stock of the employer corporation. On July 1, 1954 (the specified inventory date of the trust), the trust had on hand 80 shares of class D stock. The average cost of the 10 shares distributed, on the basis of the actual cost method, is $100 computed as follows:

Shares	Purchase date	Cost per share	Total cost
20	June 24, 1954	$101	$2,020
40	Jan. 10, 1953	102	4,080
20	Oct. 20, 1952	95	1,900
80			8,000

Example (2). B, a distributee who makes his income tax returns on the basis of a calendar year, receives on October 31, 1954, in a total distribution, to which paragraph (a) (6) of this section is applicable, 20 shares of class E stock of the employer corporation. The specified inventory date of the trust is the last day of each calendar year. The trust had on hand on December 31, 1952, 1,000 shares of class E stock of the employer corporation. During the calendar year 1953 the trust distributed to four distributees a total of 100 shares of such stock and acquired, through a number of purchases, a total of 120 shares. The average cost of the 20 shares distributed to B, on the basis of the moving average method, is $52 computed as follows:

	Shares	Total cost	Average cost
On hand Dec. 31, 1952	1,000	$50,000	$50
Distributed during 1953 at average cost of $50	100	5,000	
	900	45,000	
Purchased during 1953	120	8,040	
On hand Dec. 31, 1953	1,020	53,040	52

(3) *Unrealized appreciation attributable to employee contributions.* In any case in which it is necessary to determine the amount of net unrealized appreciation in securities of the employer corporation which is attributable to contributions made by an employee:

(i) The cost or other basis of the securities to the trust and the amount of net unrealized appreciation shall first be determined in accordance with the regulations in subparagraph (2) of this paragraph;

(ii) The amount contributed by the employee to the purchase of the securities shall be solely the portion of his actual contributions to the trust properly allocable to such securities, and shall not include any part of the increment in the trust fund expended in the purchase of the securities;

(iii) The amount of net unrealized appreciation in the securities distributed which is attributable to the contributions of the employee shall be that proportion of the net unrealized appreciation determined under the regulations of subparagraph (2) of this paragraph which the contributions of the employee properly allocable to such securities bear to the cost or other basis to the trust of the securities;

(iv) If a distribution consists solely of securities of the employer corporation, the contributions of the employee expended in the purchase of such securities shall be allocated to the securities distributed in a manner consistent with the principles set forth in subparagraph (2) (ii) (*a*), (*b*), (*c*), or (*d*) of this paragraph, whichever is applicable. Thus, the amount of the employee's contribution which can be identified as having been expended in the purchase of a particular security shall be allocated to such security, and the amount of such contribution which cannot be so identified shall be allocated ratably among the securities distributed. If a distribution consists in part of securities of the employer corporation and in part of cash or other property, appropriate allocation of a portion of the employee's contribution to such cash or other property shall be made unless such allocation is inconsistent with the terms of the plan or trust.

(v) The application of this subparagraph may be illustrated by the following example:

Example. A trust distributes ten shares of stock issued by the employer corporation each of which has an average cost to the trust of $100, consisting of employee contributions in the amount of $60 and employer contributions in the amount of $40, and on the date of distribution has a fair market value of $180. The portion of the net unrealized appreciation attributable to the contributions of the employee with respect to each of the shares of stock is $48 computed as follows:

(1) Value of one share of stock on distribution date	$180
(2) Employee contributions	60
(3) Employer contributions	40
(4) Total contributions	100
(5) Net unrealized appreciation	80
(6) Portion of net unrealized appreciation attributable to employee contributions, 60/100 (amount of employee contributions (item 2) over total contributions (item 4) of $80 (item 5))	48

(vi) For the purpose of determining gain or loss to the distributee in the year or years in which any share of stock referred to in the example in subdivision (v) of this subparagraph is sold or otherwise disposed of in a taxable transaction, the basis of each such share in the hands of the distributee at the time of the distribution by the trust will be $132 computed as follows:

(*a*) Employee contributions	$60
(*b*) Employer contributions (taxable as ordinary income in the year the securities were distributed)	40
(*c*) Portion of net unrealized appreciation attributable to employer contributions (item (5) minus item (6)) (taxable as ordinary income in the year the securities were distributed)	32
(*d*) Basis of stock	132

(4) *Change in exempt status of trust.* For principles applicable in making appropriate adjustments if the trust was not exempt for one or more years before the year of distribution, see paragraph (a) of this section.

§ 1.402(b) Statutory provisions; taxability of beneficiary of employees' trust; non-exempt trust.

SEC. 402. *Taxability of beneficiary of employees' trust.* * * *

(b) *Taxability of beneficiary of non-exempt trust.* Contributions to an employees' trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt from tax under section 501 (a) shall be included in the gross income of an employee for the taxable year in which the contribution is made to the trust in the case of an employee whose beneficial interest in such contribution is nonforfeitable at the time the contribution is made. The amount actually distributed or made available to any distributee by any such trust shall be taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities) except that section 72 (e) (3) shall not apply.

§ 1.402(b)–1 Treatment of beneficiary of a trust not exempt under section 501(a).

(a) *Taxation by reason of employer contributions.* (1) Except as provided in section 402(d), any contribution made by an employer on behalf of an employee to a trust during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under section 501 (a), shall be included in income of the employee for his taxable year during which the contribution is made if the employee's beneficial interest in the contribution is nonforfeitable at the time the contribution is made. If the employee's beneficial interest in the contribution is forfeitable at the time the contribution is made even though his interest becomes nonforfeitable later, the amount of such contribution is not required to be included in the income of the employee at the time his interest becomes nonforfeitable.

(2) (i) An employee's beneficial interest in the contribution is nonforfeitable within the meaning of sections 402 (b), 403 (b), and 404 (a) (5) at the time the contribution is made if there is no contingency under the plan which may cause

the employee to lose his rights in the contribution. For example, if under the terms of a pension plan, an employee upon termination of his services before the retirement date, whether voluntarily or involuntarily, is entitled to a deferred annuity contract to be purchased with the employer's contributions made on his behalf, or is entitled to annuity payments which the trustee is obligated to make under the terms of the trust instrument based on the contributions made by the employer on his behalf, the employee's beneficial interest in such contributions is nonforfeitable.

(ii) On the other hand, if, under the terms of a pension plan, an employee will lose the right to any annuity purchased from, or to be provided by, contributions made by the employer if his services should be terminated before retirement, his beneficial interest in such contributions is forfeitable.

(iii) The mere fact that an employee may not live to the retirement date, or may live only a short period after the retirement date, and may not be able to enjoy the receipt of annuity or pension payments, does not make his beneficial interest in the contributions made by the employer on his behalf forfeitable. If the employer's contributions have been irrevocably applied to purchase an annuity contract for the employee, or if the trustee is obligated to use the employer's contributions to provide an annuity for the employee provided only that the employee is alive on the dates the annuity payments are due, the employee's rights in the employer's contributions are nonforfeitable.

(b) *Taxation of distributions from trust not exempt under section 501 (a).* Any amount actually distributed or made available to any distributee by an employees' trust which is not exempt under section 501 (a) for the taxable year of the trust in which the distribution is made shall be taxable in the year in which so distributed or made available, under section 72 (relating to annuities), except that section 72 (e) (3) shall not apply. If, for example, the distribution from such a trust consists of an annuity contract, the amount of the distribution shall be considered to be the entire value of the contract at the time of distribution, and such value is includible in the gross income of the distributee at the time of the distribution to the extent that such value exceeds the investment in the contract determined by applying sections 72 and 101 (b). The distributions by such an employees' trust shall be taxed as provided in section 72, whether or not the employee's rights to the contributions were nonforfeitable when the contributions were made or at any time thereafter. For rules relating to the treatment of employer contributions to a non-exempt trust as part of the consideration paid by the employee, see section 72 (f). For rules relating to the treatment of the limited exclusion allowable under section 101 (b) (2) (D) as additional consideration paid by the employee, see the regulations under that section.

§ 1.402(c) Statutory provisions; taxability of beneficiary of employees' trust; certain foreign situs trusts.

SEC. 402. *Taxability of beneficiary of employees' trust.* * * *

(c) *Taxability of beneficiary of certain foreign situs trusts.* For purposes of subsections (a) and (b), a stock bonus, pension, or profit-sharing trust which would qualify for exemption from tax under section 501 (a) except for the fact that it is a trust created or organized outside the United States shall be treated as if it were a trust exempt from tax under section 501 (a).

§ 1.402(c)–1 Taxability of beneficiary of certain foreign situs trusts.

Section 402(c) has the effect of treating, for purposes of section 402, the distributions from a trust which at the time of the distribution is located outside the United States in the same manner as distributions from a trust which is located in the United States. If the trust would qualify for exemption from tax under section 501(a) except for the fact that it fails to comply with the provisions of paragraph (a)(3)(i) of § 1.401–1, which restricts qualification to trusts created or organized in the United States and maintained here, section 402 (a) and § 1.402 (a)–1 are applicable to the distributions from such a trust. Thus, for example, a total distribution from such a trust is entitled to the long-term capital gains treatment of section 402 (a) (2), except in the case of a nonresident alien individual (see sections 871 and 1441 and the regulations thereunder). However, if the plan fails to meet any requirement of section 401 and the regulations thereunder in addition to paragraph (a) (3) (i) of § 1.401–1, section 402 (b) and § 1.402 (b)–1 are applicable to the distributions from such a trust.

§ 1.402(d) Statutory provisions; taxability of beneficiary of employees' trust; annuities under agreements entered into prior to October 21, 1942.

SEC. 402. *Taxability of beneficiary of employees' trust.* * * *

(d) *Certain employees' annuities.* Notwithstanding subsection (b) or any other provision of this subtitle, a contribution to a trust by an employer shall not be included in the gross income of the employee in the year in which the contribution is made if—

(1) Such contribution is to be applied by the trustee for the purchase of annuity contracts for the benefit of such employee;

(2) Such contribution is made to the trustee pursuant to a written agreement entered into prior to October 21, 1942, between the employer and the trustee, or between the employer and the employee; and

(3) Under the terms of the trust agreement the employee is not entitled during his lifetime, except with the consent of the trustee, to any payments under annuity contracts purchased by the trustee other than annuity payments.

The employee shall include in his gross income the amounts received under such contracts for the year received as provided in section 72 (relating to annuities) except that section 72 (e) (3) shall not apply. This subsection shall have no application with respect to amounts contributed to a trust after June 1, 1949, if the trust on such date was exempt under section 165 (a) of the Internal Revenue Code of 1939. For purposes of this subsection, amounts paid by an employer for the purchase of annuity contracts which are transferred to the trustee shall be deemed to be contributions made to a trust or trustee and contributions applied by the trustee for the purchase of annuity contracts; the term "annuity contracts purchased by the trustee" shall include annuity contracts so purchased by the employer and transferred to the trustee; and the term "employee" shall include only a person who was in the employ of the employer, and was covered by the agreement referred to in paragraph (2), prior to October 21, 1942.

§ 1.402(d)–1 Effect of section 402(d).

(a) If the requirements of section 402(d) are met, a contribution made by an employer on behalf of an employee to a trust which is not exempt under section 501 (a) shall not be included in the income of the employee in the year in which the contribution is made. Such contribution will be taxable to the employee, when received in later years, as provided in section 72 (relating to annuities), except that section 72 (e) (3) shall not apply. See paragraph (b) of § 1.403 (b)–1. The intent and purpose of section 402 (d) is to give those employees, covered under certain non-exempt trusts to which such section applies, essentially the same tax treatment as those covered by trusts described in section 401 (a) and exempt under section 501 (a), except that the capital gains treatment referred to in section 402 (a) (2) does not apply.

(b) Every person claiming the benefit of section 402 (d) must be able to demonstrate to the satisfaction of the Commissioner that all of the provisions of such section are met. The taxpayer must produce sufficient evidence to prove:

(1) That, before October 21, 1942, he was employed by the particular employer making the contribution in question and was at such time definitely covered by a written agreement, entered into before October 21, 1942, between himself and the employer, or between the employer and the trustee of a trust established by the employer before October 21, 1942, and that the contribution by the employer was made pursuant to such agreement. The fact that an employee may have been potentially covered is not sufficient. Evidence that the employment was entered into, or the agreement executed, "as of" a date before October 21, 1942, or that the agreement or trust instrument which did not theretofore meet the requirements of section 402 (d) was modified or amended after October 20, 1942, so as to come within the provisions of such section, will not satisfy the requirements of section 402 (d).

(2) That such contribution, pursuant to the terms of such agreement, was to be applied for the purchase of an annuity contract for the taxpayer. In the case of a contribution by the employer of an annuity contract purchased by such employer and transferred by him to the trustee of the trust, evidence should be presented to prove that such contract was purchased for the taxpayer by the employer pursuant to the terms of a written agreement between the employer and the employee or between the employer and the trustee, entered into before October 21, 1942.

(3) That under the written terms of the trust agreement the taxpayer is not

entitled during his lifetime, except with the consent of the trustee, to any payments other than annuity payments under the annuity contract or contracts purchased by the trustee or by the employer and transferred to the trustee, and that the trustee may grant or withhold such consent free from control by the taxpayer, the employer, or any other person. However, such control will not be presumed from the fact that the trustee is himself an officer or employee of the employer. As used in section 402 (d) the phrase "if * * * under the terms of the trust agreement the employee is not entitled" means that the trust instrument must make it impossible for the prohibited distribution to occur, whether by operation or natural termination of the trust, whether by power of revocation or amendment, other than with the consent of the trustee, whether by the happening of a contingency, by collateral arrangement, or any other means. It is not essential that the employer relinquish all power to modify or terminate the trust but it must be impossible, except with the consent of the trustee, for any payments under annuity contracts purchased by the trustee, or by the employer and transferred to the trustee, to be received by the taxpayer, directly or indirectly, other than as annuity payments.

(4) The nature and amount of such contribution and the extent to which income taxes have been paid thereon before January 1, 1949, and not credited or refunded.

(5) If it is claimed that section 402 (d) applies to amounts contributed to a trust after June 1, 1949, the taxpayer must prove to the satisfaction of the Commissioner that the trust did not, on June 1, 1949, qualify for exemption under section 165 (a) of the Internal Revenue Code of 1939. Where an employer buys an annuity contract which is transferred to the trustee, the date of the purchase of the annuity contract and not the date of the transfer to the trustee is the controlling date in determining whether or not the contribution was made to the trust after June 1, 1949.

§ 1.402(c) Statutory provisions; taxability of beneficiary of employees' trust; certain plan terminations.

SEC. 402. *Taxability of beneficiary of employees' trust.* * * *

(c) *Certain plan terminations.* For purposes of subsection (a) (2), distributions made after December 31, 1953, and before January 1, 1955, as a result of the complete termination of a stock bonus, pension, or profit-sharing plan of an employer which is a corporation, if the termination of the plan is incident to the complete liquidation, occurring before the date of enactment of this title, of the corporation, whether or not such liquidation is incident to a reorganization as defined in section 368 (a), shall be considered to be distributions on account of separation from service.

§ 1.402(c)–1 Certain plan terminations.

Distributions made after December 31, 1953, and before January 1, 1955, as a result of the complete termination of an employees' trust described in section 401 (a) which is exempt under section 501 (a) shall be considered distributions on account of separation form service for purposes of section 402 (a) (2) if the employer who established the trust is a corporation, and the termination of the plan is incident to the complete liquidation of the corporation before August 16, 1954, regardless of whether such liquidation is incident to a reorganization as defined in section 368.

§ 1.403(a) Statutory provisions; taxation of employee annuities; qualified annuity plan.

SEC. 403. *Taxation of employee annuities*—(a) *Taxability of beneficiary under a qualified annuity plan*—(1) *General rule.* Except as provided in paragraph (2), if an annuity contract is purchased by an employer for an employee under a plan with respect to which the employer's contribution is deductible under section 404 (a) (2), or if an annuity contract is purchased for an employee by an employer described in section 501 (c) (3) which is exempt from tax under section 501 (a), the employee shall include in his gross income the amounts received under such contract for the year received as provided in section 72 (relating to annuities) except that section 72 (e) (3) shall not apply.

(2) *Capital gains treatment for certain distributions*—(A) *General rule.* If—

(i) An annuity contract is purchased by an employer for an employee under a plan which meets the requirements of section 401 (a) (3), (4), (5), and (6);

(ii) Such plan requires that refunds of contributions with respect to annuity contracts purchased under such plan be used to reduce subsequent premiums on the contracts under the plan; and

(iii) The total amounts payable by reason of an employee's death or other separation from the service, or by reason of the death of an employee after the employee's separation from the service, are paid to the payee within one taxable year of the payee,

then the amount of such payments, to the extent exceeding the amount contributed by the employee (determined by applying section 72 (f)), which employee contributions shall be reduced by any amounts theretofore paid to him which were not includible in gross income, shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months.

(B) *Definition.* For purposes of subparagraph (A), the term "total amounts" means the balance to the credit of an employee which becomes payable to the payee by reason of the employee's death or other separation from the service, or by reason of his death after separation from the service.

§ 1.403(a)–1 Taxability of beneficiary under a qualified annuity plan.

(a) An employee or retired or former employee for whom an annuity contract is purchased by his employer is not required to include in his gross income the amount paid for the contract at the time such amount is paid, whether or not his rights to the contract are forfeitable, if—

(1) The annuity contract is purchased under a plan with respect to which the amounts paid by the employer are deductible under section 404 (a) (2), or

(2) The annuity contract is purchased under a plan which meets the requirements of section 404 (a) (2) although the employer does not deduct the amounts paid for the contract under such section, or

(3) The annuity contract is purchased by an employer which is an organization described in section 501 (c) (3) and exempt under section 501 (a) provided the purchase of the annuity is merely a supplement to past or current compensation. For the purpose of this subparagraph, whether the purchase of an annuity contract is merely a "supplement to past or current compensation" is to be determined by all the surrounding facts and circumstances. One of the pertinent facts to be taken into consideration is the ratio of the consideration paid by the employer for an employee's contract to the amount of his past or current compensation. For example, if the annual premium paid for an employee's contract is $1,000 and his annual salary is $10,000, the ratio indicates that the premium paid for the contract is merely a supplement to the employee's current compensation. If, however, an employee receives no current compensation, or the annual premiums paid for his annuity contract approximate his annual salary, the amount paid for his contract will be considered to be current compensation and taxable to the employee in the year in which it is paid by the employer. Other pertinent considerations are whether the annuity contract is purchased as a result of an agreement for a reduction of the employee's annual salary, or whether it is purchased at his request in lieu of an increase in current compensation to which he otherwise might be entitled. In such cases, the amount paid for the contract shall also be considered to be current compensation.

(b) The amounts received by or made available to any employee referred to in paragraph (a) of this section under such annuity contract shall be included in gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities) except that section 72 (e) (3) shall not apply, and except that certain total distributions described in section 403 (a) (2) are taxable as long-term capital gains. For the treatment of such total distributions, see § 1.403 (a)–2.

(c) If upon the death of an employee or of a retired employee, the widow or other beneficiary of such employee is paid, in accordance with the terms of the annuity contract relating to the deceased employee, an annuity or other death benefit, the extent to which the amounts received by or made available to the beneficiary must be included in the beneficiary's income under section 403 (a) shall be determined in accordance with the rules presented in paragraph (a) (5) of § 1.402 (a)–1.

(d) If under a qualified annuity plan a group contract providing group permanent life insurance protection is purchased for the employees, the same regulations which are applicable when contracts providing life insurance protection are purchased by a trust described in section 401 (a) and exempt under section 501 (a), shall be applicable in the case of such a contract. For such regulations, see paragraph (a) (2), (3), and (4) of § 1.402 (a)–1. Section 403 (a) is not applicable to premiums paid after October 26, 1956, for individual contracts provid-

ing life insurance protection for employees.

(e) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701 (a) (20).

§ 1.403(a)–2 Capital gains treatment for certain distributions.

(a) If the total amounts payable with respect to any employee for whom an annuity contract has been purchased by an employer under a plan which—

(1) Meets the requirements of section 401 (a) (3), (4), (5), and (6), and

(2) Requires that refunds of contributions with respect to annuity contracts purchased under such plan be used to reduce subsequent premiums on the contracts under the plan,

are paid to, or includible in gross income of, the payee within one taxable year of the payee by reason of the employee's death or other separation from the service, or death after such separation from the service, such total payments, to the extent they exceed the net amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. The "net amount contributed by the employee" is the amount actually contributed by the employee plus any amounts considered to be contributed by the employee under the rules of sections 72 (f), 101 (b), and paragraph (d) of § 1.403 (a)–1, reduced by any amounts theretofore distributed to him which were excludable from his gross income as a return of employee contributions. For example, if under an annuity contract purchased under a plan described in this section, the total distributions payable to the employee's widow are paid to her in the year in which the employee dies, in the amount of $8,000, and if $5,000 thereof is excludable under section 101 (b), and if the employee made contributions of $600 and had received no payments, the remaining amount of $2,400 will be considered a gain from the sale or exchange of a capital asset held for more than six months.

(b) (1) The term "total amounts" means the balance to the credit of an employee with respect to all annuities under the annuity plan which becomes payable to the payee by reason of the employee's death or other separation from the service, or by reason of his death after separation from the service. If an employee commences to receive annuity payments on retirement and then a lump sum payment is made to his widow upon his death, the capital gains treatment applies to the lump sum payment, but it does not apply to amounts received before the time the "total amounts" become payable. However, if the total amount to the credit of the employee at the time of his death or other separation from the service or death after separation from the service is paid or includible in the gross income of the payee within one taxable year of the payee, such amount is entitled to the capital gains treatment notwithstanding that in a later taxable year an additional amount is credited to the employee and paid to the payee.

(2) If more than one annuity contract is received under the plan, the capital gains treatment does not apply to any amount received on the surrender thereof unless all contracts under the plan with respect to a particular employee are surrendered either at the time of the employee's death or other separation from the service or death after separation from the service. Thus, if an employee receives two contracts on separation from the service and surrenders one of them in the year of separation and receives payments under the other until his death, the capital gains treatment is applicable to the balance paid to his beneficiary on his death if paid within one taxable year of the beneficiary. The amount received by the employee on surrender of the contract in the year of his separation from the service, however, would not receive capital gains treatment since the balance to the credit of the employee with respect to all amounts under the plan did not become payable at that time.

(3) If an employee retires and commences to receive an annuity but subsequently in some succeeding taxable year, he is paid a lump sum in settlement of all future annuity payments, the capital gains treatment does not apply to such lump sum settlement paid during the lifetime of the employee since it is not a payment on account of separation from the service, or death after separation, but is on account of the settlement of future annuity payments.

(4) If the "total amounts" payable under all annuity contracts under the plan with respect to a particular employee are paid or includible in the gross income of several payees within one taxable year on account of the employee's death or other separation from the service or on account of his death after separation from the service, the capital gains treatment is applicable. Thus, if the balance to the credit of a deceased employee under all annuity contracts provided under an annuity plan becomes payable to two payees, the capital gains treatment is applicable provided the "total amounts" payable are received by or includible in the gross income of both payees within the same taxable year. However, if the "total amounts" payable are made available to each payee and one elects to receive his share in cash while the other makes a timely election under section 72 (h) to receive his share as an annuity, the capital gains treatment does not apply to either payee.

§ 1.403(b) Statutory provisions; taxation of employee annuities; nonqualified annuity.

SEC. 403. *Taxation of employee annuities.* * * *

(b) *Taxability of beneficiary under a nonqualifier annuity.* If an annuity contract purchased by an employer for an employee is not subject to subsection (a) and the employee's rights under the contract are nonforfeitable, except for failure to pay future premiums, the amount contributed by the employer for such annuity contract on or after such rights become nonforfeitable shall be included in the gross income of the employee in the year in which the amount is contributed. The employee shall include in his gross income the amounts received under such contract for the year received as provided in section 72 (relating to annuities) except that section 72 (e) (3) shall not apply.

§ 1.403(b)–1 Taxability of beneficiary under a nonqualified annuity.

(a) Except as provided in section 402 (d), if an employer purchases an annuity contract and if the amounts paid for the contract are not subject to paragraph (a) of § 1.403 (a)–1, the amount of such contribution shall be included in the income of the employee for the taxable year during which such contribution is made if, at the time the contribution is made, the employees' rights under the annuity contract are nonforfeitable, except for failure to pay future premiums. If the employee's rights under the annuity contract in such a case were forfeitable at the time the employer's contribution was made for the annuity contract, even though they become nonforfeitable later, the amount of such contribution is not required to be included in the income of the employee at the time his rights under the contract become nonforfeitable. As to what constitutes nonforfeitable rights of an employee, see § 1.402 (b)–1. The amounts received by or made available to the employee under the annuity contract shall be included in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities) except that section 72 (e) (3) shall not apply. For rules relating to the treatment of employer contributions as part of the consideration paid by the employee, see section 72 (f). See also section 101 (b) (2) (D) for rules relating to the treatment of the limited exclusion provided thereunder as part of the consideration paid by the employee.

(b) If an employer has purchased annuity contracts and transferred the same to a trust or if an employer has made contributions to a trust for the purpose of providing annuity contracts for his employees as provided in section 402 (d) (see paragraph (a) of § 1.402 (d)–1), the amount so paid or contributed is not required to be included in the income of the employee, but any amount received by or made available to the employee under the annuity contract shall be includible in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities), except that section 72 (e) (3) shall not apply. In such case the amount paid or contributed by the employer shall not constitute consideration paid by the employee for such annuity contract in determining the amount of annuity payments required to be included in his gross income under section 72 unless the employee has paid income tax for any taxable year beginning before January 1, 1949, with respect to such payment or contribution by the employer for such year and such tax is not credited or refunded to the employee. In the event such tax has been paid and not credited or refunded the amount paid or contributed by the employer for such year shall constitute consideration paid by the employee for the annuity contract in determining the amount of the annuity required to be included in the income of the employee under section 72.

§ 1.404(a) Statutory provisions; deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan; general rule.

SEC. 404. *Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan*—(a) *General rule.* If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income) but if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

(1) *Pension trusts.* In the taxable year when paid, if the contributions are paid into a pension trust, and if such taxable year ends within or with a taxable year of the trust for which the trust is exempt under section 501 (a), in an amount determined as follows:

(A) An amount not in excess of 5 percent of the compensation otherwise paid or accrued during the taxable year to all the employees under the trust, but such amount may be reduced for future years if found by the Secretary or his delegate upon periodical examinations at not less than 5-year intervals to be more than the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan, plus

(B) Any excess over the amount allowable under subparagraph (A) necessary to provide with respect to all of the employees under the trust the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each such employee, as determined under regulations prescribed by the Secretary or his delegate, but if such remaining unfunded cost with respect to any 3 individuals is more than 50 percent of such remaining unfunded cost, the amount of such unfunded cost attributable to such individuals shall be distributed over a period of at least 5 taxable years, or

(C) In lieu of the amounts allowable under subparagraphs (A) and (B) above, an amount equal to the normal cost of the plan, as determined under regulations prescribed by the Secretary or his delegate, plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount not in excess of 10 percent of the cost which would be required to completely fund or purchase such pension or annuity credits as of the date when they are included under regulations

except that in no case shall a deduction be allowed for any amount (other than the normal cost) paid in after such pension or annuity credits are completely funded or purchased.

(D) Any amount paid in a taxable year in excess of the amount deductible in such year under the foregoing limitations shall be deductible in the succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each such succeeding year and the maximum amount deductible for such year in accordance with the foregoing limitations.

(2) *Employees' annuities.* In the taxable year when paid, in an amount determined in accordance with paragraph (1), if the contributions are paid toward the purchase of retirement annuities and such purchase is a part of a plan which meets the requirements of section 401 (a) (3), (4), (5), and (6), and if refunds of premiums, if any, are applied within the current taxable year or next succeeding taxable year towards the purchase of such retirement annuities.

(3) *Stock bonus and profit-sharing trusts*—(A) *Limits on deductible contributions.* In the taxable year when paid, if the contributions are paid into a stock bonus or profit-sharing trust, and if such taxable year ends within or with a taxable year of the trust with respect to which the trust is exempt under section 501 (a), in an amount not in excess of 15 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the stock bonus or profit-sharing plan. If in any taxable year there is paid into the trust, or a similar trust then in effect, amounts less than the amounts deductible under the preceding sentence, the excess, or if no amount is paid, the amounts deductible, shall be carried forward and be deductible when paid in the succeeding taxable years in order of time, but the amount so deductible under this sentence in any such succeeding taxable year shall not exceed 15 percent of the compensation otherwise paid or accrued during such succeeding taxable year to the beneficiaries under the plan. In addition, any amount paid into the trust in any taxable year in excess of the amount allowable with respect to such year under the preceding provisions of this subparagraph shall be deductible in the succeeding taxable years in order of time, but the amount so deductible under this sentence in any one such succeeding taxable year together with the amount allowable under the first sentence of this subparagraph shall not exceed 15 percent of the compensation otherwise paid or accrued during such taxable year to the beneficiaries under the plan. The term "stock bonus or profit-sharing trust", as used in this subparagraph, shall not include any trust designed to provide benefits upon retirement and covering a period of years, if under the plan the amounts to be contributed by the employer can be determined actuarially as provided in paragraph (1). If the contributions are made to 2 or more stock bonus or profit-sharing trusts, such trusts shall be considered a single trust for purposes of applying the limitations in this subparagraph.

(B) *Profit-sharing plan of affiliated group.* In the case of a profit-sharing plan, or a stock bonus plan in which contributions are determined with reference to profits, of a group of corporations which is an affiliated group within the meaning of section 1504, if any member of such affiliated group is prevented from making a contribution which it would otherwise have made under the plan, by reason of having no current or accumulated earnings or profits or because such earnings or profits are less than the contributions which it would otherwise have made, then so much of the contribution which such member was so prevented from making may be made, for the benefit of the employees of such member, by the other members of the group, to the extent of current or accumulated earnings or profits, except that such contribution by each such other member shall be limited, where the group does not file a consolidated return, to that proportion of its total current and accumulated earnings or profits remaining after adjustment for its contribution deductible without regard to this subparagraph which the total prevented contribution bears to the total current and accumulated earnings or profits of all the members of the group remaining after adjustment for all contributions deductible without regard to this subparagraph. Contributions made under the preceding sentence shall be deductible under subparagraph (A) of this paragraph by the employer making such contribution, and, for the purpose of determining amounts which may be carried forward and deducted under the second sentence of subparagraph (A) of this paragraph in succeeding taxable years, shall be deemed to have been made by the employer on behalf of whose employees such contributions were made.

(4) *Trusts created or organized outside the United States.* If a stock bonus, pension, or profit-sharing trust would qualify for exemption under section 501 (a) except for the fact that it is a trust created or organized outside the United States, contributions to such a trust by an employer which is a resident, or corporation, or other entity of the United States, shall be deductible under the preceding paragraphs.

(5) *Other plans.* In the taxable year when paid, if the plan is not one included in paragraph (1), (2), or (3), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

(6) *Taxpayers on accrual basis.* For purposes of paragraphs (1), (2), and (3), a taxpayer on the accrual basis shall be deemed to have made a payment on the last day of the year of accrual if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

(7) *Limit of deduction.* If amounts are deductible under paragraphs (1) and (3), or (2) and (3), or (1), (2), and (3), in connection with 2 or more trusts, or one or more trusts and an annuity plan, the total amount deductible in a taxable year under such trusts and plans shall not exceed 25 percent of the compensation otherwise paid or accrued during the taxable year to the persons who are the beneficiaries of the trusts or plans. In addition, any amount paid into such trust or under such annuity plans in any taxable year in excess of the amount allowable with respect to such year under the preceding provisions of this paragraph shall be deductible in the succeeding taxable years in order of time, but the amount so deductible under this sentence in any one such succeeding taxable year together with the amount allowable under the first sentence of this paragraph shall not exceed 30 percent of the compensation otherwise paid or accrued during such taxable years to the beneficiaries under the trusts or plans. This paragraph shall not have the effect of reducing the amount otherwise deductible under paragraphs (1), (2), and (3), if no employee is a beneficiary under more than one trust, or a trust and an annuity plan.

§ 1.404(a)–1 Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan; general rule.

(a) (1) Section 404(a) prescribes limitations upon deductions for amounts contributed by an employer under a pension, annuity, stock bonus, or profit-sharing plan, or under any plan of deferred compensation. It is immaterial whether the plan covers present employees only, or present and former employees, or only former employees. Section 404 (a) also governs the deductibility of unfunded pensions and death benefits paid directly to former employees or their beneficiaries (see § 1.404 (a)–12).

(2) Section 404 (a) does not apply to a plan which does not defer the receipt of compensation. Furthermore, section 404 (a) does not apply to deductions for contributions under a plan which is solely a dismissal wage or unemployment benefit plan, or a sickness, accident, hospitalization, medical expense, recreation, welfare, or similar benefit plan, or a combination thereof. For example, if under

a plan an employer contributes 5 percent of each employee's compensation per month to a fund out of which employees who are laid off will be paid benefits for temporary periods, but employees who are not laid off have no rights to the funds, such a plan is an unemployment benefit plan, and the deductibility of the contributions to it is determined under section 162. As to the deductibility of such contributions, see § 1.162–9.

(3) If, however, the contributions to a pension, profit-sharing, stock bonus, or other plan of deferred compensation can be used to provide any of the benefits referred to in subparagraph (2) of this paragraph, then, except as provided in section 404 (c), section 404 (a) applies to the entire contribution to the plan. Thus, if in the example described in subparagraph (2) of this paragraph, the employer's contribution on behalf of each employee is set up as a separate account, and if any amount which remains in an employee's account at the time of retirement is paid to him at such time, the deductibility of the contributions to the plan is determined under section 404 (a). For the regulations for determining whether the benefits referred to in subparagraph (2) of this paragraph can be included in a qualified pension or profit-sharing plan, see § 1.401–1 (b).

(4) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701 (a) (20).

(b) In order to be deductible under section 404 (a), contributions must be expenses which would be deductible under section 162 (relating to trade or business expenses) or 212 (relating to expenses for production of income) if it were not for the provision in section 404 (a) that they are deductible, if at all, only under section 404 (a). Contributions may therefore be deducted under section 404 (a) only to the extent that they are ordinary and necessary expenses during the taxable year in carrying on the trade or business or for the production of income and are compensation for personal services actually rendered. In no case is a deduction allowable under section 404 (a) for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered. What constitutes a reasonable allowance depends upon the facts in the particular case. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year. A contribution under a plan which is primarily for the benefit of shareholders of the employer is not deductible. Such a contribution may constitute a dividend within the meaning of section 316. See also §§ 1.162–6 and 1.162–8. In addition to the limitations referred to above, deductions under section 404 (a) are also subject to further conditions and limitations particularly provided therein.

(c) Deductions under section 404 (a) are generally allowable only for the year in which the contribution or compensation is paid, regardless of the fact that the taxpayer may make his returns on the accrual method of accounting. Exceptions are made in the case of overpayments as provided in paragraphs (1), (3), and (7) of section 404 (a), and, as provided by section 404 (a) (6), in the case of payments made by a taxpayer on the accrual method of accounting not later than the time prescribed by law for filing the return for the taxable year of accrual (including extensions thereof). This latter provision is intended to permit a taxpayer on the accrual method to deduct such accrued contribution or compensation in the year of accrual, provided payment is actually made not later than the time prescribed by law for filing the return for the taxable year of accrual (including extensions thereof), but this provision is not applicable unless, during the taxable year on account of which the contribution is made, the taxpayer incurs a liability to make the contribution, the amount of which is accruable under section 461 for such taxable year. See section 461 and the regulations thereunder. There is another exception in the case of certain taxpayers who are required to make additional contributions as a result of the Act of June 15, 1955 (Public Law 74, 84th Cong., 69 Stat. 134), and the regulations thereunder.

§ 1.404(a)–2 Information to be furnished by employer claiming deductions.

(a) For the first taxable year for which a deduction from gross income is claimed under section 404 (a) (1), (2), (3), or (7), the employer must file the following information (unless such information has been previously filed in accordance with the regulations under section 23 (p) of the Internal Revenue Code of 1939) for each plan involved to establish that it meets the requirements of section 401 (a) or 404 (a) (2), and that deductions claimed do not exceed the amount allowable under paragraphs (1), (2), (3), and (7) of section 404 (a), as the case may be:

(1) Verified copies of all the instruments constituting or evidencing the plan, including trust indentures, group annuity contracts, specimen copy of each type of individual contract, and specimen copy of formal announcement and comprehensive detailed description to employees, with all amendments to any such instruments.

(2) A statement describing the plan which identifies it and which sets forth the name or names of the employers, the effective date of the plan and of any amendments thereto, the method of distribution or of disbursing benefits (whether by trustee, insurance company, or otherwise), the dates when the instruments or amendments were executed, the date of formal announcement and the dates when comprehensive detailed description of the plan and of each amendment thereto were made available to employees generally, the dates when the plan and when the trust or the contract evidencing the plan and of any amendments thereto were put into effect so that contributions thereunder were irrevocable and a summary of the provisions and rules relating to—

(i) Employee eligibility requirements for participation in the plan,

(ii) Employee contributions,

(iii) Employer contributions,

(iv) The basis or formula for determining the amount of each type of benefit and the requirements for obtaining such benefits and the vesting conditions,

(v) The medium of funding (e. g., self-insured, unit purchase group annuity contract, individual level annual premium retirement endowment insurance contracts, etc.) and, if not wholly insured, the medium of contributions and the kind of investments, and

(vi) The discontinuance or modification of the plan and distributions or benefit payments upon liquidation or termination.

(3) A tabulation in columnar form showing the information specified below with respect to each of the 25 highest paid employees covered by the plan in the taxable year, listed in order of their nondeferred compensation (where there are several plans of deferred compensation, the information for each of the plans may be shown on a single tabulation without repetition of the information common to the several plans):

(i) Name.

(ii) Whether an officer.

(iii) Percentage of each class of stock owned directly or indirectly by the employee or members of his family.

(iv) Whether the principal duties consist in supervising the work of other employees.

(v) Year of birth.

(vi) Length of service for employer to the close of the year.

(vii) Total nondeferred compensation paid or accrued during the taxable year with a breakdown of such compensation into the following components:

(*a*) Basic compensation and overtime pay,

(*b*) Other direct payments, such as bonuses and commissions,

(*c*) Compensation paid other than in cash, such as goods, services, insurance not directly related to the benefits or provided from funds under the plan, etc.

(viii) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto), less the employee's contributions during the year, under each other plan of deferred compensation.

(ix) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related

thereto), less the employee's contributions during the year, under the plan. If a profit-sharing or stock bonus plan, also a breakdown of such amounts into the following components:

(*a*) Amounts originally allocated in the year, and

(*b*) Amounts reallocated in the year.

(x) Amounts of employee contributions during the year under the plan,

(xi) If a pension or annuity plan,

(*a*) The retirement age and date and the form of the retirement benefit,

(*b*) The annual rate or amount of the retirement benefit, and

(*c*) The aggregate of all of the employee's contributions under the plan, all based, in the case of an employee who is not on retirement benefit under the plan, upon the assumption of his continued employment at his current rate of compensation until his normal retirement age (or the end of the current year if later) and retirement on such date with the normal form of retirement benefit under the plan..

(4) The following totals:

(i) Total nondeferred compensation paid or accrued during the taxable year for all employees covered under the plan and also for all employees of the employer.

(ii) Total amount allocated during the year for the benefit of employees, former or retired employees, or their beneficiaries (including any insurance provided thereby or directly related thereto), less employee contributions during the year under the plan and, if a profit-sharing or stock bonus plan, also a breakdown of such total into the following components:

(*a*) Amount originally allocated in the year, and

(*b*) Amount reallocated in the year.

(5) A schedule showing the total number of employees as of the close of the year for each of the following groups, based on reasonable estimates:

(i) All employees ineligible for coverage under the plan because of requirements as to employment classification, specifying the reasons applicable to the group (as, for example, temporary, seasonal, part time, hourly pay basis, etc.).

(ii) All employees ineligible for coverage under the plan because of requirements as to length of service and not included in subdivision (i) of this subparagraph.

(iii) All employees ineligible for coverage under the plan because of requirements as to minimum age and not included in subdivision (i) or (ii) of this subparagraph.

(iv) All employees ineligible for coverage under the plan solely because of requirements as to minimum rate of compensation.

(v) All employees ineligible for coverage under the plan other than those employees included in subdivision (i), (ii), (iii), or (iv) of this subparagraph, specifying the reason applicable to the group.

(vi) All employees ineligible for coverage under the plan for any reasons, which should be the sum of subdivisions (i) to (v), inclusive, of this subparagraph.

(vii) All employees eligible for coverage but not covered under the plan.

(viii) All employees covered under the plan.

(ix) All employees of the employer, which should be the sum of subdivisions (vi), (vii), and (viii) of this subparagraph.

If it is claimed that the requirements of section 401 (a) (3) (A) are satisfied, also the data and computations necessary to show that such requirements are satisfied.

(6) In the case of a trust, a detailed balance sheet and a detailed statement of receipts and disbursements during the year; in the case of a nontrusteed annuity plan, a detailed statement of the names of the insurers, the contributions paid by the employer and by the employees, and a statement as to the amounts and kinds of premium refunds or similar credits made available and the disposition of such credits in the year.

(7) If a pension or annuity plan, a detailed description of all the methods, factors, and assumptions used in determining costs and in adjusting the costs for actual experience under the plan (including any loadings, contingency reserves, or special factors and the basis of any insured costs or liabilities involved therein) explaining their source and application in sufficient detail to permit ready analysis and verification thereof, and, in the case of a trust, a detailed description of the basis used in valuing the investments held. Also a summary of the resulting costs or liabilities and adjustments for the year under the pension or annuity plan in sufficient detail to permit ready verification of the reasonableness thereof.

(8) A statement of the applicable limitations under section 404 (a) (1), (2), (3), or (7) and an explanation of the method of determining such limitations and a summary of the data and computations necessary to determine the allowable deductions for the taxable year.

(9) A statement of the contributions paid in the taxable year, showing the date and amount of each payment. Also a summary of the deductions claimed for the taxable year for the plan with a breakdown of the deductions claimed into the following components:

(i) For contributions paid in the taxable year before giving effect to the provisions of paragraph (7) of section 404 (a).

(ii) For contributions paid in prior taxable years beginning after December 31, 1941, in accordance with the carryover provisions of paragraphs (1) and (3) of section 404 (a), before giving effect to the provisions of paragraph (7) thereof, and in accordance with the carryover provisions of section 404 (d).

(iii) Any reductions or increases in the deductions in accordance with the provisions of paragraph (7) of section 404 (a).

(b) For taxable years subsequent to the year for which all of the applicable information under paragraph (a) of this section (or corresponding provisions of prior regulations) has been filed, information is to be filed only to the following extent:

(1) If there is any change in the plan, instruments, methods, factors, or assumptions upon which the data and information specified in paragraph (a) (1), (2), or (7) of this section are based, a detailed statement explaining the change and its effect is to be filed only for the taxable year in which the change is put into effect. However, if there is no such change, unless otherwise requested by the district director, merely a statement that there is no such change is to be filed.

(2) The information specified in paragraph (a) (3) of this section which has been filed for a taxable year, unless otherwise requested by the district director and so long as the plan and the method and basis of allocations are not changed, is to be filed for subsequent years only to the extent of showing in the tabulation such information with respect to employees who, at any time in the taxable year, own, directly or indirectly, more than 5 percent of the voting stock, considering stock so owned by an individual's spouse or minor lineal descendant as owned by the individual for this purpose.

(3) The information specified in paragraph (a) (4), (5), (6), (8), and (9) of this section.

(c) If a deduction is claimed under section 404 (a) (5) for the taxable year, the taxpayer shall furnish such information as is necessary to show that the deduction is not allowable under the other paragraphs of section 404 (a), that the amount paid is an ordinary and necessary expense or an expense for the production of income, and that the employees' rights to, or derived from, such employer's contribution or such compensation were nonforfeitable at the time the contribution or compensation was paid.

(d) For the purpose of the information required by this section, contributions paid in a taxable year should include those deemed to be so paid in accordance with the provisions of section 404 (a) (6) and should exclude those deemed to be paid in the prior taxable year in accordance with such provisions. As used in this section, "taxable year" refers to the taxable year of the employer and, unless otherwise requested by the district director, a "year" which is not specified as a "taxable year" may be taken as the taxable year of the employer or as the plan, trust, valuation, or group contract year with respect to which deductions are being claimed provided the same rule is followed consistently so that there is no gap or overlap in the information furnished for each item. In any case the date or period to which each item of information furnished relates should be clearly shown. All the information required by this section should be filed with the tax return for the taxable year in which the deduction is claimed except that, unless sooner requested by the district director, such information, other than that specified in paragraph (a) (4) (i) and (9) of this section, may be filed within 12 months after the close of the taxable year provided there is filed with the tax return a statement that the information cannot reasonably be filed therewith, setting forth the reasons therefor.

paragraph.

(e) In any case all the information and data required by this section must be filed in the office of the district director in which the employer files his tax returns and identified for association with the appropriate returns and must be filed independently of any information and data otherwise submitted in connection with a determination of the qualification of the trust or plan under section 401 (a). The district director may, in addition, require any further information that he considers necessary to determine allowable deductions under section 404 or qualification under section 401 and may waive the filing of such information required herein which he finds unnecessary in a particular case.

(f) Records substantiating all data and information required by this section to be filed must be kept at all times available for inspection by internal revenue officers at the main office or place of business of the employer.

§ 1.404(a)–3 Contributions of an employer to or under an employees' pension trust or annuity plan that meets the requirements of section 401(a); application of section 404(a)(1).

(a) If contributions are paid by an employer to or under a pension trust or annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a) (1) or (2) if the further conditions provided therein are also satisfied. As used in this section, a "pension trust" means a trust forming part of a pension plan and an "annuity plan" means a pension plan under which retirement benefits are provided under annuity or insurance contracts without a trust. This section is also applicable to contributions to a foreign situs pension trust which could qualify for exemption under section 501(a) except that it is not created or organized and maintained in the United States. For the meaning of "pension plan" as used in this section, see paragraph (b) (1) (i) of § 1.401–1. Where disability pensions, insurance, or survivorship benefits incidental and directly related to the retirement benefits under a pension or annuity plan are provided for the employees or their beneficiaries by contributions under the plan, deductions on account of such incidental benefits are also covered under section 404 (a) (1) or (2). See paragraph (a) (3) of § 1.402 (a)–1 as to taxability to employees of cost of incidental insurance protection. In order to be deductible under section 404 (a) (1), contributions to a pension trust must be paid in a taxable year of the employer which ends with or within a year of the trust for which it is exempt under section 501 (a). In order that contributions carried over may be deducted in a succeeding taxable year of the employer in accordance with section 404 (a) (1) (D), the succeeding year also must end with or within a taxable year of the trust for which it is exempt under section 501 (a). See § 1.404 (a)–8 as to conditions for deductions under section 404 (a) (2) in the case of an annuity plan. In either case, the deductions are also subject to further limitations provided in section 404 (a) (1). The limitations provided in section 404 (a) (1) are, with an exception provided for certain years under subparagraph (A) thereof (see § 1.404 (a)–4), based on the actuarial costs of the plan.

(b) In determining costs for the purpose of limitations under section 404 (a) (1), the effects of expected mortality and interest must be discounted and the effects of expected withdrawals, changes in compensation, retirements at various ages, and other pertinent factors may be discounted or otherwise reasonably recognized. A properly weighted retirement age based on adequate analyses of representative experience may be used as an assumed retirement age. Different basic assumptions or rates may be used for different classes of risks or different groups where justified by conditions or required by contract. In no event shall costs for the purpose of section 404 (a) (1) exceed costs based on assumptions and methods which are reasonable in view of the provisions and coverage of the plan, the funding medium, reasonable expectations as to the effects of mortality and interest, reasonable and adequate regard for other factors such as withdrawal and deferred retirement (whether or not discounted) which can be expected to reduce costs materially, reasonable expenses of operation, and all other relevant conditions and circumstances. In any case, in determining the costs and limitations, an adjustment shall be made on account of any experience more favorable than that assumed in the basis of limitations for prior years. Unless such adjustments are consistently made every year by reducing the limitations otherwise determined by any decrease in liability or cost arising from experience in the next preceding taxable year which was more favorable than the assumptions on which the costs and limitations were based, the adjustment shall be made by some other method approved by the Commissioner.

(c) The amount of a contribution to a pension or annuity plan that is deductible under section 404 (a) (1) or (2) depends upon the methods, factors, and assumptions which are used to compute the costs of the plan and the limitation of section 404 (a) (1) which is applied. Since the amount that is deductible for one taxable year may affect the amount that is deductible for other taxable years, the methods, factors, and assumptions used in determining costs and the method of determining the limitation which have been used for determining the deduction for a taxable year for which the return has been filed shall not be changed for such taxable year, except when the Commissioner determines that the methods, factors, assumptions, or limitations were not proper, or except when a change is necessitated by reason of the use of different methods, factors, assumptions, or limitations for another taxable year. However, different methods, factors, and assumptions, or a different method of determining the limitation, if they are proper, may be used in determining the deduction for a subsequent taxable year. In any case, see paragraphs (a) (7) and (8) and (b) (1) and (3) of § 1.404 (a)–2 for the information which must be submitted regarding the methods, factors, assumptions, and limitations.

(d) Any expenses incurred by the employer in connection with the plan, such as trustee's and actuary's fees, which are not provided for by contributions under the plan are deductible by the employer under section 162 (relating to trade or business expenses), or 212 (relating to expenses for production of income) to the extent that they are ordinary and necessary.

(e) In case deductions are allowable under section 404 (a) (3), as well as under section 404 (a) (1) or (2), the limitations under section 404 (a) (1) and (3) are determined and applied without giving effect to the provisions of section 404 (a) (7) but the amounts allowable as deductions are subject to the further limitations provided in section 404 (a) (7). See § 1.404 (a)–13.

§ 1.404(a)–4 Pension and annuity plans; limitations under section 404 (a)(1)(A).

(a) Subject to the applicable general conditions and limitations (see § 1.404 (a)–3), the initial limitation under section 404(a)(1)(A) is 5 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the pension or annuity plan. This initial 5-percent limitation applies to the first taxable year for which a deduction is allowed for contributions to or under such a plan and also applies to any subsequent year for which the 5-percent figure is not reduced as provided in this section. For years to which the initial 5-percent limitation applies, no adjustment on account of prior experience is required. If the contributions do not exceed the initial 5-percent limitation in the first taxable year to which this limitation applies, the taxpayer need not submit actuarial data for such year.

(b) For the first taxable year following the first year to which the initial 5-percent limitation applies, and for every fifth year thereafter, or more frequently where preferable to the taxpayer, the taxpayer shall submit with his return an actuarial certification of the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan with a statement explaining all the methods, factors, and assumptions used in determining such amount. This amount may be determined as the sum of (1) the unfunded past service cost as of the beginning of the year, and (2) the normal cost for the year. Such costs shall be determined by methods, factors, and assumptions appropriate as a basis of limitations under section 404 (a) (1) (C). Whenever requested by the district director, a similar certification and statement shall be submitted for the year or years specified in such request. The district director will make periodical examinations of such data at not less than 5-year intervals. Based upon such examinations the Commissioner will reduce the limitation under section 404 (a) (1) (A) below the 5-percent limitation for the years with respect to which he finds that the 5-percent limitation

exceeds the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan. Where the limitation is so reduced, the reduced limitation shall apply until the Commissioner finds that a subsequent actuarial valuation shows a change to be necessary. Such subsequent valuation may be made by the taxpayer at any time and submitted to the district director with a request for a change in the limitation.

(c) For the purpose of limitations under section 404 (a) (1) (A), "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401 (a), including a plan that qualifies under section 404 (a) (2). Where two or more pension or annuity plans cover the same employee, under section 404 (a) (1) (A) the deductions with respect to each such plan are subject to the limitations applicable to the particular plan and the total deductions for all such plans are also subject to the limitations which would be applicable thereto if they constituted a single plan. Where, because of the particular provisions applicable to a large class of employees under a plan, the costs with respect to such employees are nominal in comparison with their compensation, after the first year to which the initial 5-percent limitation applies, deductions under section 404 (a) (1) (A) are subject to limitations determined by considering the plan applicable to such class as if it were a separate plan. Deductions are allowable to the extent of the applicable limitations under section 404 (a) (1) (A) even where these are greater than the applicable limitations under section 404 (a) (1) (B) or section 404 (a) (1) (C).

§ 1.404(a)–5 Pension and annuity plans; limitations under section 404 (a)(1)(B).

(a) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), under section 404(a)(1)(B), deductions may be allowed to the extent of limitations based on costs determined by distributing the remaining unfunded cost of the past and current service credits with respect to all employees covered under the trust or plan as a level amount or level percentage of compensation over the remaining service of each such employee except that, as to any three individuals with respect to whom more than 50 percent of such remaining unfunded cost is attributable, the remaining unfunded cost attributable to such individuals shall be distributed evenly over a period of at least five taxable years.

(b) The statutory limitation for any taxable year under section 404 (a) (1) (B) is any excess of the amount of the costs described in paragraph (a) of this section for the year over the amount allowable as a deduction under section 404 (a) (1) (A).

(c) For this purpose, such excess, adjusted for prior experience, may be computed for each year as follows, all determinations being made as of the beginning of the year:

(1) Determine the value of all benefits expected to be paid after the beginning of the year for all employees, any former employees, and any other beneficiaries, then covered under the plan.

(2) If employees contribute under the plan, determine the value of all contributions expected to be made after the beginning of the year by employees then covered under the plan.

(3) Determine the value of all funds of the plan as of the beginning of the year.

(4) Determine the amount remaining to be distributed as a level amount or as a level percentage of compensation over the remaining future service of each employee by subtracting from subparagraph (1) of this paragraph the sum of subparagraphs (2) and (3) of this paragraph.

(5) Determine the value of all compensation expected to be paid after the beginning of the year to all employees then covered under the plan.

(6) Determine an accrual rate for each employee by dividing subparagraph (5) of this paragraph into subparagraph (4) of this paragraph.

(7) Compute the excess under section 404 (a) (1) (B) for the year by multiplying the compensation paid to all employees covered under the plan during the year by any excess of subparagraph (6) of this paragraph over 5 percent. In general, where this method is used, the limitation under section 404 (a) (1) (B) will be equal to the excess so computed without further adjustment on account of prior favorable experience, provided all the factors and assumptions used are reasonable in view of all applicable considerations (see § 1.404 (a)–3) and provided subparagraph (5) of this paragraph is not less than five times the annual rate of compensation in effect at the beginning of the year.

(d) Instead of determining the excess deductible under section 404 (a) (1) (B) by the method shown in paragraph (c), such excess may be based upon cost determined by some other method which is reasonable and appropriate under the circumstances. Thus, such excess may be based on the amounts necessary with respect to each individual covered employee to provide the remaining unfunded cost of all his benefits under the plan distributed as a level amount over the period remaining until the normal commencement of his retirement benefits, in accordance with other generally accepted actuarial methods which are reasonable and appropriate in view of the provisions of the plan, the funding medium, and other applicable considerations.

§ 1.404(a)–6 Pension and annuity plans; limitations under section 404 (a)(1)(C).

(a) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), in lieu of amounts deductible under the limitations of section 404(a)(1)(A) and section 404(a)(1)(B), deductions may be allowed under section 404 (a) (1) (C) to the extent of limitations based on normal and past service or supplementary costs of providing benefits under the plan. "Normal cost" for any year is the amount actuarially determined which would be required as a contribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. Past service or supplementary cost at any time is the amount actuarially determined which would be required at such time to meet all the future benefits provided under the plan which would not be met by future normal costs and employee contributions with respect to the employees covered under the plan at such time.

(b) The limitation under section 404 (a) (1) (C) for any taxable year is the sum of normal cost for the year plus an amount not in excess of one-tenth of the past service or supplementary cost as of the date the past service or supplementary credits are provided under the plan. For this purpose the normal costs may be determined by any generally accepted actuarial method and may be expressed either as (1) the aggregate of level amounts with respect to each employee covered under the plan, (2) a level percentage of payroll with respect to each employee covered under the plan, or (3) the aggregate of the single premium or unit costs for the unit credits accruing during the year with respect to each employee covered under the plan, provided, in any case, that the method is reasonable in view of the provisions and coverage of the plan, the funding medium, and other applicable considerations. The limitation may include one-tenth of the past service or supplementary cost as of the date the provisions resulting in such cost were put into effect, but it is subject to adjustments for prior favorable experience. See § 1.404 (a)–3. In any case, past service or supplementary costs shall not be included in the limitation for any year in which the amount required to fund fully or to purchase such past service or supplementary credits has been deducted, since no deduction is allowable for any amount (other than the normal cost) which is paid in after such credits are fully funded or purchased.

§ 1.404(a)–7 Pension and annuity plans; contributions in excess of limitations under section 404(a)(1); application of section 404(a)(1)(D).

Where contributions paid by an employer in a taxable year to or under a pension or annuity plan exceed the limitations applicable under section 404(a)(1) but otherwise satisfy the conditions for deduction under section 404(a)(1) or (2), then in accordance with section 404(a)(1)(D), the excess contributions are carried over and are deductible in succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each succeeding year and the limitation applicable to such year under section 404 (a) (1) (A), (B), or (C). The provisions of section 404 (a) (1) (D) are to be ap-

plied before giving effect to the provisions of section 404 (a) (7) for any year. The carryover provisions of section 404 (a) (1) (D), before effect has been given to section 404 (a) (7), may be illustrated by the following example for a plan put into effect in a taxable year ending December 31, 1954:

Taxable year ending Dec. 31, 1954:	
Amount of contributions paid in year	$100,000
Limitation applicable to year	60,000
Amount deductible for year	60,000
Excess carried over to succeeding years	40,000
Taxable year ending Dec. 31, 1955:	
Amount of contributions paid in year	$25,000
Carried over from previous years	40,000
Total deductible subject to limitation	65,000
Limitation applicable to year	50,000
Amount deductible for year	50,000
Excess carried over to succeeding years	15,000
Taxable year ending Dec. 31, 1956:	
Amount of contributions paid in year	$10,000
Carried over from previous years	15,000
Total deductible subject to limitation	25,000
Limitation applicable to year	45,000
Amount deductible for year	25,000
Excess carried over to succeeding years	None

§ 1.404(a)–8 Contributions of an employer under an employees' annuity plan which meets the requirements of section 401(a); application of section 404(a)(2).

(a) If contributions are paid by an employer under an annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404 (a)–1), the contributions are deductible under section 404 (a) (2) if the further conditions provided therein are satisfied. For the meaning of "annuity plan" as used here, see § 1.404 (a)–3. In order that contributions by the employer may be deducted under section 404 (a) (2), all of the following conditions must be satisfied:

(1) The contributions must be paid toward the purchase of retirement annuities (or for disability, severance, insurance, or survivorship benefits incidental and directly related to such annuities) under an annuity plan for the exclusive benefit of the employer's employees or their beneficiaries. See paragraph (a) of § 1.401–1.

(2) The contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it meets the applicable requirements with respect to discrimination set out in section 401 (a) (3), (4), (5), and (6). In order that contributions carried over may be deducted in a succeeding taxable year of the employer in accordance with section 404 (a) (1) (D), the succeeding year also must end with or within a taxable year of the plan for which it meets such requirements. See §§ 1.401–3 and 1.401–4. These requirements are considered to be satisfied for the period beginning with the date on which an annuity plan was put into effect and ending with the fifteenth day of the third month following the close of the taxable year of the employer in which the plan was put into effect, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. See section 401 (b) and § 1.401–5. It should be noted that the period in which a plan may be amended to qualify under section 401 (b) ends before the date taxpayers, other than corporations, are required to file income tax returns.

(3) There must be a definite written arrangement between the employer and the insurer that refunds of premiums, if any, shall be applied within the taxable year of the employer in which received or within the next succeeding taxable year toward the purchase of retirement annuities (or for disability, severance, insurance, or survivorship benefits incidental and directly related to such annuities) under the plan. For the purpose of this condition, "refunds of premiums" means payments by the insurer on account of credits such as dividends, experience rating credits, or surrender or cancellation credits. The arrangement may be in the form of contract provisions or written directions of the employer or partly in one form and partly in another. This condition will be considered satisfied where—

(i) All credits are applied regularly, as they are determined, toward the premiums next due under the contracts before any further employer contributions are so applied, and

(ii) Under the arrangement,

(*a*) No refund of premiums may be made during continuance of the plan unless applied as aforesaid, and

(*b*) If refunds of premiums may be made after discontinuance of the plan on account of surrenders or cancellations before all retirement annuities provided under the plan with respect to service before its discontinuance have been purchased, such refunds will be applied in the taxable year of the employer in which received, or in the next succeeding taxable year, to purchase retirement annuities for employees by a procedure which does not contravene the conditions of section 401 (a) (4).

(b) Where the above conditions are satisfied, the amounts of deductions under section 404 (a) (2) are governed by the limitations provided in section 404 (a) (1). See §§ 1.404 (a)–3 to 1.404 (a)–7, inclusive.

§ 1.404(a)–9 Contributions of an employer to an employees' profit-sharing or stock bonus trust that meets the requirements of section 401(a); application of section 404(a)(3)(A).

(a) If contributions are paid by an employer to a profit-sharing or stock bonus trust for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a)(3)(A) if the further conditions provided therein are also satisfied. In order to be deductible under section 404(a)(3)(A) the contributions must be paid in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a) and the trust must not be designed to provide retirement benefits for which the contributions can be determined actuarially. In order that contributions carried over may be deducted in a succeeding taxable year of the employer in accordance with the third sentence of section 404(a)(3)(A), the succeeding year also must end with or within a taxable year of the trust for which it is exempt under section 501(a). This section is also applicable to contributions to a foreign situs profit-sharing or stock bonus trust which could qualify for exemption under section 501(a) except that it is not created or organized and maintained in the United States.

(b) The amount of deductions under section 404 (a) (3) (A) for any taxable year is subject to limitations based on the compensation otherwise paid or accrued during such taxable year to the employees who, in such year, are beneficiaries of the trust funds accumulated under the plan. For this purpose "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401 (a), including a plan that qualifies under section 404 (a) (2). The limitations under section 404 (a) (3) (A) apply to the total amount deductible for contributions to the trust regardless of the manner in which the funds of the trust are invested, applied, or distributed, and no other deduction is allowable on account of any benefits provided by contributions to the trust or by the funds thereof. Where contributions are paid to two or more profit-sharing or stock bonus trusts satisfying the conditions for deduction under section 404 (a) (3) (A), such trusts are considered as a single trust in applying these limitations.

(c) The primary limitation on deductions for a taxable year is 15 percent of the compensation otherwise paid or accrued during such taxable year to the employees who, in such year, are beneficiaries of the trust funds accumulated under the plan. So long as the contributions do not in any year exceed the primary limitation, this is the only limitation under section 404 (a) (3) (A) which has any effect.

(d) In order that the deductions may average 15 percent of compensation otherwise paid or accrued over a period of years, where contributions in some taxable year are less than the primary limitation but contributions in some succeeding taxable year exceed the primary limitation, deductions in each succeeding year are subject to a secondary limitation instead of to the primary limitation. The secondary limitation for any year is equal to the lesser of (1) twice the primary limitation for the year, or (2) any excess of (i) the aggregate of the primary limitations for the year and for all prior years over (ii) the aggregate of the de-

ductions allowed or allowable under the limitations provided in section 404 (a) (3) (A) for all prior years.

(e) In any case where the contributions in a taxable year exceed the amount allowable as a deduction for the year under section 404 (a) (3) (A), the excess is deductible in succeeding taxable years, in order of time, in which the contributions are less than the primary limitations. However, the total deduction for any such succeeding year cannot exceed the lesser of (1) the primary limitation for such year, or (2) the sum of the contributions in such year and the excess contributions not deducted under the limitations of section 404 (a) (3) (A) for prior years.

(f) In case deductions are allowable under section 404 (a) (1) or (2), as well as under section 404 (a) (3) (A), the limitations under section 404 (a) (1) and (3) (A) are determined and applied without giving effect to the provisions of section 404 (a) (7), but the amounts allowable as deductions are subject to the further limitations provided in section 404 (a) (7). See § 1.404 (a)–13.

(g) The provisions of section 404 (a) (3) (A) before giving effect to section 404 (a) (7), may be illustrated as follows:

ILLUSTRATION OF PROVISIONS OF SECTION 404 (a) (3) (A) FOR A PLAN PUT INTO EFFECT IN THE TAXABLE (CALENDAR) YEAR 1954, BEFORE GIVING EFFECT TO SECTION 404 (a) (7)

[All figures represent thousands of dollars]

	Taxable (calendar) years						
	1954	1955	1956	1957	1958	1959	1960
1. Amount of contributions:							
(i) In taxable year	$65 0	$10 8	$15 0	$100 0	$70 4	$40 5	$30 3
(ii) Carried over from prior taxable years							
2. Primary limitation applicable to year: 15 percent of covered compensation in year [1]	57	54	51	48	45	42	39
3. Secondary limitation applicable to year:							
(i) Twice primary limitation				96	90	84	
(ii) (a) Aggregate primary limitations (see item 2)				210	255	297	
(b) Aggregate prior deductions (see item 4 (iii))				90	186	255	
(c) Excess of (a) over (b)				120	69	42	
(iii) Lesser of (i) or (ii)				96	69	42	
4. Amount deductible for year on account of:							
(i) Contributions in year	57 0	10 8	15 0	96 .0	69 0	40 2	30 3
(ii) Contributions carried over							
(iii) Total	57 8	18 0	15 0	96 4	69 5	42 3	33 0
5. Excess contributions carried over to succeeding years							

[1] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries of trust funds accumulated under the plan in the year.

§ 1.404(a)–10 Profit-sharing plan of an affiliated group; application of section 404(a)(3)(B).

(a) Section 404(a)(3)(B) allows a corporation a deduction to the extent provided in paragraphs (b) and (c) of this section for a contribution which it makes for another corporation to a profit-sharing plan or a stock bonus plan under which contributions are determined by reference to profits, provided the following tests are met:

(1) The corporation for which the contribution is made and the contributing corporation are members of an affiliated group of corporations as defined in section 1504, relating to the filing of consolidated returns, and both such corporations participate in the plan. However, it is immaterial whether all the members of such group participate in the plan.

(2) The corporation for which the contribution is made is required under the plan to make the contribution, but such corporation is prevented from making such contribution because it has neither current nor accumulated earnings or profits, or because its current and accumulated earnings or profits are insufficient to make the required contribution. To the extent that such a corporation has any current or accumulated earnings or profits, it is not considered to be prevented from making its required contribution to the plan.

(3) The contribution is made out of the current or accumulated earnings or profits of the contributing corporation.

(b) The amount that is deductible under section 404 (a) (3) (B) is determined by applying the rules of section 404 (a) (3) (A) and § 1.404 (a)–9 as if the contribution were made by the corporation for which it is made. For example, the primary limitation described in paragraph (e) of § 1.404 (a)–9 is determined by reference to the compensation otherwise paid or accrued to the employees of the corporation for which the contribution is made, and the secondary limitation described in paragraph (d) of § 1.404 (a)–9 and the contribution carryover described in paragraph (c) of § 1.404 (a)–9 are determined by reference to the prior contributions and deductions of such corporation. The contributing corporation may deduct the amount so determined subject to the limitations contained in paragraph (c) of this section. The contributing corporation shall not treat such amount as a contribution made by it in applying the rules of section 404 (a) (3) (A) and § 1.404 (a)–9 either for the taxable year for which the contribution is made or for succeeding taxable years. The corporation for which the contribution is made shall treat the contribution as having been made by it in applying the rules of section 404 (a) (3) (A) and § 1.404 (a)–9 for succeeding taxable years.

(c) The allowance of the deduction under section 404 (a) (3) (B) does not depend upon whether the affiliated group does or does not file a consolidated return. If a consolidated return is filed, it is immaterial which of the participating corporations makes the contribution and takes the deduction or how the contribution or the deduction is allocated among them. However, if a consolidated return is not filed, the contribution which is deductible under section 404 (a) (3) (B) by each contributing corporation shall be limited to that portion of its total current and accumulated earnings or profits (adjusted for its contribution deductible without regard to section 404 (a) (3) (B)) which the prevented contribution bears to the total current and accumulated earnings or profits of all the participating members of the group having such earnings or profits (adjusted for all contributions deductible without regard to section 404 (a) (3) (B)). For the purpose of this section, current earnings or profits shall be computed as of the close of the taxable year without diminution by reason of any dividends during the taxable year, and accumulated earnings or profits shall be computed as of the beginning of the taxable year.

(d) The application of section 404 (a) (3) (B) may be illustrated by the following example in which the affiliated group does not file a consolidated return:

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
A	($10,000)	($140,000)	($150,000)	$200,000	1/5	$6,000			6/326 × 91,000	$1,674.85
B	(5,000)	105,000	100,000	300,000	3/10	9,000	$9,000	$91,000		
C	75,000	175,000	250,000	500,000	1/2	15,000	15,000	235,000	6/326 × 235,000	4,325.15
Total	60,000	140,000	200,000	1,000,000		30,000	24,000	326,000		6,000.00

Column
(1) Member.
(2) Earnings and profits of the taxable year.
(3) Accumulated earnings and profits at beginning of taxable year.
(4) Total current and accumulated earnings and profits (column 2 plus column 3).
(5) Compensation of participating employees.
(6) Contribution formula: 50 percent of consolidated earnings and profits, allocated among participating members in proportion of covered payroll of each to covered payroll of consolidated group.
(7) Individual contribution had it not been prevented.
(8) Individual contribution made by each employer for its own employees.
(9) Balance of accumulated earnings and profits (column 4 minus column 8).
(10) Proportion of make-up contribution.
(11) Make-up contribution.

§ 1.404(a)–11 Trusts created or organized outside the United States; application of section 404(a)(4).

In order that a trust may constitute a qualified trust under section 401(a) and be exempt under section 501(a), it must be created or organized in the United States and maintained at all times as a domestic trust. See paragraph (a) of § 1.401–1. Paragraph (4) of section 404 (a) provides, however, that an employer which is a resident, a corporation, or other entity of the United States, making contributions to a foreign stock bonus, pension, or profit-sharing trust, shall be allowed deductions for such contributions, under the applicable conditions and within the prescribed limits of section 404(a), if such foreign trust would qualify for exemption under section 501 (a) except for the fact that it is a trust created, organized, or maintained outside the United States. Moreover, if a nonresident alien individual, foreign corporation, or other entity is engaged in trade or business within the United States and makes contributions to a foreign stock bonus, pension, or profit-sharing trust, which would qualify under section 401(a) and be exempt under section 501(a) except that it is created, organized, or maintained outside the United States, such contributions are deductible subject to the conditions and limitations of section 404(a) and to the extent allowed by section 873 or 882(c).

§ 1.404(a)–12 Contributions of an employer under a plan that does not meet the requirements of section 401 (a); application of section 404(a) (5).

Section 404(a)(5) covers all cases for which deductions are allowable under section 404 (a) but not allowable under paragraph (1), (2), (3), (4), or (7) of such section. No deduction is allowable under section 404 (a) (5) for any contribution paid or accrued by an employer under a stock bonus, pension, profit-sharing, or annuity plan, or for any compensation paid or accrued on account of any employee under a plan deferring the receipt of such compensation, except in the year when paid, and then only to the extent allowable under section 404 (a). See § 1.404 (a)–1. If payments are made under such a plan and the amounts are not deductible under the other paragraphs of section 404 (a), they are deductible under paragraph (5) of such subsection to the extent that the rights of individual employees to, or derived from, such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid. If unfunded pensions are paid directly to former employees, their rights to such payments are nonforfeitable, and accordingly, such amounts are deductible under section 404 (a) (5) when paid. Similarly, if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing his salary for a reasonable period), and if such amounts meet the requirements of section 162 or 212, such amounts are deductible under section 404 (a) (5) in any case when they are not deductible under the other paragraphs of section 404 (a). As to what constitutes nonforfeitable rights of an employee in other cases, see § 1.402 (b)–1. If an amount is accrued but not paid during the taxable year, no deduction is allowable for such amount for such year. If an amount is paid during the taxable year to a trust or under a plan and the employee's rights to such amounts are forfeitable at the time the amount is paid, no deduction is allowable for such amount for any taxable year.

§ 1.404(a)–13 Contributions of an employer where deductions are allowable under section 404(a) (1) or (2) and also under section 404(a) (3); application of section 404(a) (7).

(a) Where deductions are allowable under section 404(a) (1) or (2) on account of contributions under a pension or annuity plan and deductions are also allowable under section 404(a)(3) for the same taxable year, on account of contributions to a profit-sharing or stock bonus trust, the total deductions under these sections are subject to the provisions of section 404(a)(7) unless no employee who is a beneficiary under the trusts or plans for which deductions are allowable under section 404(a) (1) or (2) is also a beneficiary under the trusts for which deductions are allowable under section 404(a)(3). The provisions of section 404 (a)(7) apply only to deductions for overlapping trusts or plans, i.e., for all trusts or plans for which deductions are allowable under section 404 (a) (1), (2), or (3) except (1) any trust or plan for which deductions are allowable under section 404 (a) (1) or (2) and which does not cover any employee who is also covered under a trust for which deductions are allowable under section 404 (a) (3), and (2) any trust for which deductions are allowable under section 404 (a) (3) and which does not cover any employee who is also covered under a trust or plan for which deductions are allowable under section 404 (a) (1) or (2). The limitations under section 404 (a) (7) for any taxable year are based on the compensation otherwise paid or accrued during the year to all the employees who are beneficiaries under the overlapping trusts or plans in the year. For this purpose "compensation, otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401 (a), including a plan that qualifies under section 404 (a) (2). The employees who are beneficiaries under overlapping trusts or plans in a year include all the employees who, in the year, are beneficiaries of the funds accumulated under one or more of the overlapping trusts or plans.

(b) Under section 404 (a) (7), any excess of the total amount otherwise deductible for the taxable year under section 404 (a) (1), (2), or (3) as contributions to overlapping trusts or plans over 25 percent of the compensation otherwise paid or accrued during the year to all the employees who are beneficiaries under such trusts or plans, is not deductible for such year but is deductible for succeeding taxable years, in order of time, so that the total deduction for contributions to such trusts or plans for a succeeding taxable year is equal to the lesser of—

(1) 30 percent of the compensation otherwise paid or accrued during the taxable year to all the employees who are beneficiaries under such trusts or plans in the year, or

(2) The sum of (i) the smaller of (*a*) 25 percent of the compensation otherwise paid or accrued during the taxable year to all the employees who are beneficiaries under such trusts or plans in the year, or (*b*) the total of the amounts otherwise deductible under section 404 (a) (1), (2), or (3) for the year for such trusts or plans and (ii) any carryover to the year from prior years under section 404 (a) (7), i. e., any excess otherwise deductible under section 404 (a) (1), (2), or (3), but not deducted for a prior taxable year because of the limitations under section 404 (a) (7).

(c) The limitations under section 404 (a) (7) are determined and applied after all the limitations, deductions otherwise allowable, and carryovers under section 404 (a) (1), (2), and (3) have been determined and applied, and, in particular, after effect has been given to the carryover provision in section 404 (a) (1) (D) and in the second and third sentences of section 404 (a) (3) (A). Where the limitations under section 404 (a) (7) reduce the total amount deductible, the excess deductible in succeeding years is treated as a carryover which is distinct from, and additional to, any excess contributions carried over and deductible in succeeding years under the provisions in section 404 (a) (1) (D) or in the third sentence of section 404 (a) (3) (A). The application of the provisions of section 404 (a) (7) and the treatment of carryovers for a case where the taxable years are calendar years and the overlapping trusts or plans consist of a pension trust and a profit-sharing trust put into effect in 1954 and covering the same employees may be illustrated as follows:

ILLUSTRATION OF APPLICATION OF PROVISIONS OF SECTION 404 (a) (7) AND OF TREATMENT OF CARRYOVERS FOR OVERLAPPING PENSION AND PROFIT-SHARING TRUSTS PUT INTO EFFECT IN 1954 AND COVERING THE SAME EMPLOYEES

[All figures represent thousands of dollars]

	Taxable (calendar) years			
	1954	1955	1956	1957
BEFORE GIVING EFFECT TO SECTION 404 (a) (7)				
Pension trust contributions and limitations, deductions, and carryovers under section 404 (a) (1):				
1. Contributions paid in year	$215	$85	$140	$60
2. Contributions carried over from prior years	0	5	0	20
3. Total deductible for year subject to limitation	215	90	140	80
4. Limitation applicable to year	210	175	120	85
5. Amount deductible for year	210	90	120	80
6. Contributions carried over to succeeding years	5	0	20	0

ILLUSTRATION OF APPLICATION OF PROVISIONS OF SECTION 404 (a) (7) AND OF TREATMENT OF CARRYOVERS FOR OVERLAPPING PENSION AND PROFIT-SHARING TRUSTS PUT INTO EFFECT IN 1954 AND COVERING THE SAME EMPLOYEES—Continued

	Taxable (calendar) years			
	1954	1955	1956	1957
Profit-sharing trust contributions and limitations, deductions, and carryovers under section 404 (a) (3):				
7. Contributions paid in year	$200	$125	$105	$65
8. Contributions carried over from prior years	0	35	10	0
9. Total deductible for year subject to limitation	200	160	115	65
10. Limitation applicable to year	165	150	135	[1] 110
11. Amount deductible for year	165	150	115	65
12. Contributions carried over to succeeding years	35	10	0	0
APPLICATION OF SECTION 404 (a) (7)				
Totals for pension and profit-sharing trust:				
13. Amount deductible for year under section 404 (a) (7):				
(1) 30 percent of compensation covered in year [2]	(3)	300	270	180
(2) (i) (a) 25 percent of compensation covered in year [2]	275	250	225	150
(b) Total amount otherwise deductible for year: item 5 plus item 11	375	240	235	145
(c) Smaller of (a) or (b)	275	240	225	145
(ii) Carryover from prior years under section 404 (a) (7)	0	100	40	10
(iii) Sum of (i) (c) and (ii)	275	340	265	155
(3) Amount deductible: Lesser of (1) or (2) (iii)	275	300	265	155
14. Carryover to succeeding years under section 404 (a) (7): item 13 (2) (ii) plus item 13 (2) (i) (b) minus item 13 (3)	100	40	10	0

[1] Includes carryover of 20 from 1956.
[2] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries under the trusts in the year.
[3] 30 percent limitation not applicable to first year of plan.

§ 1.404(b) Statutory provisions; deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan; method of contributions, etc., having the effect of a plan.

SEC. 404. *Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan.* * * *

(b) *Method of contributions, etc., having the effect of a plan.* If there is no plan but a method of employer contributions or compensation has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, subsection (a) shall apply as if there were such a plan.

§ 1.404(b)–1 Method of contribution, etc., having the effect of a plan; effect of section 404(b).

Section 404(a) is not confined to formal stock bonus, pension, profit-sharing, and annuity plans, or deferred compensation plans, but it includes any method of contributions or compensation having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation. Thus, where a corporation pays pensions to a retired employee or employees or to their beneficiaries in such amounts as may be determined from time to time by the board of directors or responsible officers of the company, or where a corporation is under an obligation, whether funded or unfunded, to pay a pension or other deferred compensation to an employee or his beneficiaries, there is a method having the effect of a plan deferring the receipt of compensation for which deductions are governed by section 404 (a). If an employer on the accrual basis defers paying any compensation to an employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, he shall not be allowed a deduction until the year in which the compensation is paid. This provision is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual merely because of inability to pay such compensation in the year of accrual, as, for example, where the funds of the company are not sufficient to enable payment of the compensation without jeopardizing the solvency of the company, or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year.

§ 1.404(c) Statutory provisions; deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan; certain negotiated plans.

SEC. 404. *Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan.* * * *

(c) *Certain negotiated plans.* If contributions are paid by an employer—

(1) Under a plan under which such contributions are held in trust for the purpose of paying (either from principal or income or both) for the benefit of employees and their families and dependents at least medical or hospital care, and pensions on retirement or death of employees; and

(2) Such plan was established prior to January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry in which such employer is engaged,

such contributions shall not be deductible under this section nor be made nondeductible by this section, but the deductibility thereof shall be governed solely by section 162 (relating to trade or business expenses). This subsection shall have no application with respect to amounts contributed to a trust on or after any date on which such trust is qualified for exemption from tax under section 501 (a).

§ 1.404(c)–1 Certain negotiated plans; effect of section 404(c).

(a) Section 404(a) does not apply to deductions for contributions paid by an employer under a negotiated plan which meets the following conditions:

(1) The contributions under the plan are held in trust for the purpose of paying, either from principal or income or both, for the benefit of employees and their families, at least medical or hospital care, and pensions on retirement or death of employees; and

(2) Such plan was established before January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry in which such employer is engaged.

If these conditions are met, such contributions shall be deductible under section 162, to the extent that they constitute ordinary and necessary business expenses.

(b) The term "as a result of an agreement" is intended primarily to cover a trust established under the terms of an agreement referred to in paragraph (a) (2) of this section. It will also include a trust establishd under a plan of an employer, or group of employers, who are in competition with the employers whose facilities were seized by reason of producing the same commodity, and who would therefore be expected to establish such a trust as a reasonable measure to maintain a sound position in the labor market producing the commodity. Thus, for example, if a trust was established under such an agreement in the bituminous coal industry, a similar trust established about the same time in the anthracite coal industry would be covered by this provision.

(c) If any such trust becomes qualified for exemption under section 501 (a), the deductibility of contributions by an employer to such trust on or after the date of such qualification would no longer be governed by section 404 (c), even though the trust may later lose its exemption under section 501 (a).

§ 1.404(d) Statutory provisions; deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan; carryover of unused deductions.

SEC. 404. *Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan.* * * *

(d) *Carryover of unused deductions.* The amount of any unused deductions or contributions in excess of the deductible amounts for taxable years to which this part does not apply which under section 23 (p) of the Internal Revenue Code of 1939 would be allowable as deductions in later years had such section 23 (p) remained in effect, shall be allowable as deductions in taxable years to which this part applies as if such section 23 (p) were continued in effect for such years. However, the deduction under the preceding sentence shall not exceed an

amount which, when added to the deduction allowable under subsection (a) for contributions made in taxable years to which this part applies, is not greater than the amount which would be deductible under subsection (a) if the contributions which give rise to the deduction under the preceding sentence were made in a taxable year to which this part applies.

§ 1.404(d)–1 Carryover of unused deductions; effect of section 404(d).

Contributions for taxable years which began before January 1, 1954, (or ended before August 17, 1954, regardless of when they began) in excess of the deductible limits of section 23 (p) of the Internal Revenue Code of 1939 which would have been available as carryovers and deductible in succeeding taxable years, in order of time, had such section 23 (p) remained in effect, are allowable as deductions for taxable years beginning after December 31, 1953, and ending after August 16, 1954, to the same extent that such deductions would have been allowable had such section 23 (p) remained in effect. This provision, however, does not increase a deduction for a taxable year beyond the applicable limits of section 404 (a) had the carryover constituted part of the contribution for such year. Thus, for example, if a pension plan had been put into effect as of January 1, 1953, when the past service liability was $1,000,000, and the employer contributed $500,000 in 1953, only $100,000 would be deductible in 1953 under section 23(p)(1)(A)(iii) of the Internal Revenue Code of 1939, and $400,000 was available as a carryover to 1954 under section 23(p)(1)(A)(iv). If the employer made a contribution of the remaining $500,000 in 1954, it would not result in allowable deductions of $200,000 for past service funding in that year (i.e., $100,000 under section 404(a) and another $100,000 under section 404(d)). The total allowable deduction for such funding would be only $100,000 for 1954 (10 percent of the initial past service liability of $1,000,000), and the carryover to 1955 would be $800,000. Also, unused deduction carryovers which arose under the second sentence of section 23(p)(1)(C) of the Internal Revenue Code of 1939 are continued for years beginning after December 31, 1953, as though arising under the second sentence of section 404(a)(3)(A).

MISCELLANEOUS PROVISIONS

§ 1.421 Statutory provisions; employee stock options.

SEC. 421. *Employee stock options*—(a) *Treatment of restricted stock options.* If a share of stock is transferred to an individual pursuant to his exercise after 1949 of a restricted stock option, and no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him—

(1) No income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(2) No deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which subsection (g) is applicable, with respect to the share so transferred; and

(3) No amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

This subsection and subsection (b) shall not apply unless (A) the individual, at the time he exercises the restricted stock option, is an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary of such corporation issuing or assuming a stock option in a transaction to which subsection (g) is applicable, or (B) the option is exercised by him within 3 months after the date he ceases to be an employee of such corporations.

(b) *Special rule where option price is between 85 percent and 95 percent of value of stock.* If no disposition of a share of stock acquired by an individual on his exercise after 1949 of a restricted stock option is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him, but, at the time the restricted stock option was granted, the option price (computed under subparagraph (d) (1) (A)) was less than 95 percent of the fair market value at such time of such share, then, in the event of any disposition of such share by him, or in the event of his death (whenever occurring) while owning such share, there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income, for the taxable year in which falls the date of such disposition or for the taxable year closing with his death, whichever applies—

(1) In the case of a share of stock acquired under an option qualifying under clause (i) of subparagrah (d) (1) (A), an amount equal to the amount (if any) by which the option price is exceeded by the lesser of—

(A) The fair market value of the share at the time of such disposition or death, or

(B) The fair market value of the share at the time the option was granted; or

(2) In the case of stock acquired under an option qualifying under clause (ii) of subparagraph (d) (1) (A), an amount equal to the lesser of—

(A) The excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(B) The excess of the fair market value of the share at the time the option was granted over the option price (computed as if the option had been exercised at such time).

In the case of the disposition of such share by the individual, the basis of the share in his hands at the time of such disposition shall be increased by an amount equal to the amount so includible in his gross income.

(c) *Acquisition of new stock.* If stock is received by an individual in a distribution to which section 305, 354, 355, 356, or 1036, or so much of section 1031 as relates to section 1036, applies and such distribution was made with respect to stock transferred to him upon his exercise of the option, such stock shall be considered as having been transferred to him on his exercise of such option. A similar rule shall be applied in the case of a series of such distributions.

(d) *Definitions.* For purposes of this section—

(1) *Restricted stock option.* The term "restricted stock option" means an option granted after February 26, 1945, to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if—

(A) At the time such option is granted—

(i) The option price is at least 85 percent of the fair market value at such time of the stock subject to the option, or

(ii) In case the purchase price of the stock under the option is fixed or determinable under a formula in which the only variable is the value of the stock at any time during a period of 6 months which includes the time the option is exercised, the option price (computed as if the option had been exercised when granted) is at least 85 percent of the value of the stock at the time such option is granted; and

(B) Such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(C) Such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation. This subparagraph shall not apply if at the time such option is granted the option price is at least 110 percent of the fair market value of the stock subject to the option and such option either by its terms is not exercisable after the expiration of 5 years from the date such option is granted or is exercised within one year after the date of enactment of this title. For purposes of this subparagraph—

(i) Such individual shall be considered as owning the stock owned, directly or indirectly, by or for his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(ii) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries; and

(D) Such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted, if such option has been granted on or after June 22, 1954.

(2) *Parent corporation.* The term "parent corporation" means any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time of the granting of the option, each of the corporations other than the employer corporation owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(3) *Subsidiary corporation.* The term "subsidiary corporation" means any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(4) *Disposition*—(A) *General rule.* Except as provided in subparagraph (B), the term "disposition" includes a sale, exchange, gift, or a transfer of legal title, but does not include—

(i) A transfer from a decedent to an estate or a transfer by bequest or inheritance;

(ii) An exchange to which section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies; or

(iii) A mere pledge or hypothecation.

(B) *Joint tenancy.* The acquisition of a share of stock in the name of the employee and another jointly with the right of survivorship or a subsequent transfer of a share of stock into such joint ownership shall not be deemed a disposition, but a termination of such joint tenancy (except to the extent such employee acquires ownership of such

stock) shall be treated as a disposition by him occurring at the time such joint tenancy is terminated.

(5) *Stockholder approval.* If the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval.

(6) *Exercise by estate*—(A) *In general.* If a restricted stock option is exercised subsequent to the death of the employee by the estate of the decedent, or by a person who acquired the right to exercise such option by bequest or inheritance or by reason of the death of the decedent, the provisions of this section shall apply to the same extent as if the option had been exercised by the decedent, except that—

(i) The holding period and employment requirements of subsection (a) shall not apply, and

(ii) Any transfer by the estate of stock acquired shall be considered a disposition of such stock for purposes of subsection (b).

(B) *Deduction for estate tax.* If an amount is required to be included under subsection (b) in gross income of the estate of the deceased employee or of a person described in subparagraph (A), there shall be allowed to the estate or such person a deduction with respect to the estate tax attributable to the inclusion in the taxable estate of the deceased employee of the net value for estate tax purposes of the restricted stock option. For this purpose, the deduction shall be determined under section 691 (c) as if the option acquired from the deceased employee were an item of gross income in respect of the decedent under section 691 and as if the amount includible in gross income under subsection (b) of this section were an amount included in gross income under section 691 in respect of such item of gross income.

(e) *Modification, extension, or renewal of option*—(1) *Rules of application.* For purposes of subsection (d), if the terms of any option to purchase stock are modified, extended, or renewed, the following rules shall be applied with respect to transfers of stock made on the exercise of the option after the making of such modification, extension, or renewal—

(A) Such modification, extension, or renewal shall be considered as the granting of a new option,

(B) The fair market value of such stock at the time of the granting of such option shall be considered as—

(i) The fair market value of such stock on the date of the original granting of the option,

(ii) The fair market value of such stock on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value of such stock at the time of the making of any intervening modification, extension, or renewal,

whichever is the highest.

Subparagraph (B) shall not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months before the date of the modification, extension, or renewal, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest.

(2) *Definition of modification.* The term "modification" means any change in the terms of the option which gives the employee additional benefits under the option, but such term shall not include a change in the terms of the option—

(A) Attributable to the issuance or assumption of an option under subsection (g); or

(B) To permit the option to qualify under subsection (d) (1) (B).

If an option is exercisable after the expiration of 10 years from the date such option is granted, subparagraph (B) shall not apply unless the terms of the option are also changed to make it not exercisable after the expiration of such period.

(f) *Effect of disqualifying disposition.* If a share of stock, acquired by an individual pursuant to his exercise of a restricted stock option, is disposed of by him within 2 years from the date of the granting of the option or within 6 months after the transfer of such share to him, then any increase in the income of such individual or deduction from the income of his employer corporation for the taxable year in which such exercise occurred attributable to such disposition, shall be treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occurred.

(g) *Corporate reorganization, liquidations, etc.* For purposes of this section, the term "issuing or assuming a stock option in a transaction to which subsection (g) is applicable" means a substitution of a new option for the old option, or an assumption of the old option, by an employer corporation, or a parent or subsidiary of such corporation, by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation, if—

(1) The excess of the aggregate fair market value of the shares subject to the option immediately after the substitution or assumption over the aggregate option price of such shares is not more than the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

(2) The new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.

For purposes of this subsection, the parent-subsidiary relationship shall be determined at the time of any such transaction under this subsection.

§ 1.421–1 Meaning and use of certain terms.

(a) *Option.* (1) For the purpose of section 421, the term "option" includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (d) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract.

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1954, grants to an employee the right to purchase 1,000 shares of its stock on or after June 1, 1955, another 1,000 shares on or after June 1, 1956, and a further 1,000 shares on or after June 1, 1957, all shares to be purchased before June 1, 1958, provided the employee at the time of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1954, of three options, each for the purchase of 1,000 shares. Similarly, if a corporation grants to an employee on January 1, 1955, the right to purchase 1,000 shares of its stock at $85 per share during 1955, or at $75 per share during 1956, or at $65 per share during 1957, such an arrangement will be construed as the grant to the employee on January 1, 1955, of three alternative options, one option for the purchase of 1,000 shares at $85 per share during 1955, an alternative option for the purchase of 1,000 shares at $75 per share during 1956, and a third alternative option for the purchase of 1,000 shares at $65 per share during 1957.

(b) *Time and date of granting of option.* (1) For the purpose of section 421, the words "the date of the granting of the option" and "the time such option is granted", and similar phrases refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a restricted stock option. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option), such conditions shall be given effect in accordance with the intent of the corporation. A special rule is provided by section 421 (d) (5) for options subject to stockholder approval. If the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporate action, such as the approval of some regulatory or governmental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of its

parent or subsidiary corporation, such option is not granted prior to the date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 1954, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation stock, exercisable by X on or after June 1, 1955, provided he is employed by the corporation on June 1, 1955. Such an option is granted to X on June 1, 1954.

(c) *Stock.* For the purpose of section 421, the term "stock" means capital stock of any class, including voting or nonvoting common or preferred stock. The term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term "stock" as used in section 421, provided such stock otherwise possesses the rights and characteristics of capital stock.

(d) *Option price.* (1) For the purpose of section 421, the term "option price" or "price paid under the option" means the consideration in money or property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased.

(2) With respect to its option price, a restricted stock option must, when granted, meet either of the following requirements:

(i) The option price must be fixed or determinable at the time the option is granted; or

(ii) In the case of an option exercised during any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954, the option must provide that such price shall be determined by a formula in which the only variable is the value of the stock at any time during a period of six consecutive months which includes the day on which such option is exercised. Such formula may provide for determining such price by reference to such value on any particular day in such six-month period, or by reference to an average value of the stock over either the whole of such six-month period or over any shorter period included in such six-month period. Such six-month period may begin with, end with, or in any other manner span the day on which such option is exercised. Such formula may also depend upon factors other than such value of the stock, but such other factors must not be variable and must be fixed in the option when granted. For example, such formula may provide that the option price shall be 85 percent of the value of the stock on the day the option is exercised, but such price shall not be less than $85, nor more than $110. Another example of a formula which meets the requirements of this subdivision is a provision that the option price shall be 95 percent of the fair market value of the stock on the day the option is exercised but not more than $95. However, the requirements of this subdivision are not met by a formula which provides that if the profits of the employer for the year do not exceed $100,000, the option price shall be $15 under the fair market value of the stock at the time the option is exercised, but if such profits exceed $100,000, the option price shall be $20 under such value of the stock. For an example of how to determine whether an option which contains a formula meeting the requirements of this subdivision also meets the requirement that the option price must be at least 85 percent of the fair market value of the stock at the time the option is granted, see paragraph (a) (1) of § 1.421–2.

An option which does not meet the requirements of either subdivision (i) or (ii) of this subparagraph when granted, will not be treated as a restricted stock option unless it is subsequently changed to meet such requirements. In case of such a change, see paragraph (c) (2) of § 1.421–4.

(e) *Exercise.* For the purpose of section 421, the term "exercise", when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

(f) *Transfer.* For the purpose of section 421, the term "transfer", when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a restricted stock option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation.

§ 1.421–2 Restricted stock option.

(a) *In general.* (1) A "restricted stock option" is an option granted after February 26, 1945, to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but, except in the case of options described in subparagraph (2) of this paragraph, only if—

(i) At the time such option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option; and

(ii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iii) Such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock either of the employer corporation or of its parent or subsidiary corporation; and

(iv) In the case of options granted after June 21, 1954, such option by its terms is not exercisable after the expiration of ten years from the date on which such option was granted.

For the purpose of applying the rule of subdivision (i) of this subparagraph if the option price is determined by a formula described in paragraph (d) (2) (ii) of § 1.421–1, the option price shall, notwithstanding any provision of the option, be computed as if such option is exercised on the day when it is granted. For example, if on June 15, 1954, an option is granted providing that the option price shall be $10 under the average value of the stock during the month preceding the month in which the option is exercised, and if on June 15, 1954, the value of the stock subject to the option is $100 a share, to determine if the option meets the requirement of subdivision (i) of this subparagraph, it is necessary to determine the average value of the stock during the month of May 1954. If such average value is $95 or more, the option meets the requirement of subdivision (i) of this subparagraph.

(2) Regardless of the extent to which the individual to whom the option is granted owns stock of either the employer corporation, or of its parent or subsidiary corporation, an option is a restricted stock option if—

(i) Such option is granted after February 26, 1945, to such individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations; and

(ii) At the time such option is granted the option price is at least 110 percent of the fair market value at such time of the stock subject to the option; and

(iii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iv) Such option by its terms is not exercisable after the expiration of five years from the date on which such option was granted, or such option is exercised before August 17, 1955.

(3) At the time the option is granted, the relationship between the individual to whom an option is granted and the corporation granting the option (or a corporation which is a parent or subsidiary thereof) must be the legal and bona fide relationship of employer and employee. For rules applicable to the determination whether the employer-employee relationship exists, see section 3401 (c) and the regulations thereunder. An option granted before employment or after termination of employment is not a restricted stock option. As to the granting of an option conditioned upon employment, see paragraph (b) (2) of § 1.421–1. The option must be granted for a reason connected with the individual's employment by the corporation or by its parent or subsidiary corporation.

(4) An option may qualify as a restricted stock option only if, under the terms of the option, it is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom it is granted, and is exercisable, during the lifetime of such individual, only by him. Accordingly, an option which is transferable by the

individual to whom it is granted during his lifetime, or is exercisable during such individual's lifetime by another person, is not a restricted stock option. However, in case the option contains a provision permitting the individual to whom the option was granted to designate the person who may exercise the option after his death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a restricted stock option.

(5) Any reasonable valuation methods may be used for the purpose of determining whether at the time the option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option. Such methods include the valuation methods described in § 20.2031–2 of this chapter (Estate Tax Regulations).

(b) *Ownership of 10 percent of stock.* In determining the amount of stock owned by an individual, for the purpose of applying the 10 percent test of section 421 (d) (1) (C), stock of the employer corporation or of its parent or subsidiary owned (directly or indirectly) by or for such individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, shall be considered as owned by such individual. Also, for such purpose, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) stock of the employer corporation or of its parent or subsidiary, such stock shall be considered as being owned proportionately by or for the shareholders, partners, or beneficiaries of the corporation, partnership, estate, or trust.

§ 1.421–3 Exercise of restricted stock option.

(a) The special rules of income tax treatment provided in section 421 (a) and (b) are applicable only if the following conditions exist with respect to the transfer of a share of stock to an individual:

(1) The share of stock is transferred to the individual pursuant to his exercise after 1949 of a restricted stock option; and

(2) At the time the option is exercised by him, the individual is an employee of the corporation granting such option (or parent or subsidiary thereof), or of a corporation (or parent or subsidiary thereof) which issued or assumed the option under section 421 (g) (see paragraph (d) of § 1.421–4), or was an employee of any such corporations within three months before the date the option is exercised.

(b) (1) Section 421 is applicable to the exercise of a restricted stock option only if at the time the individual exercises the option he is a bona fide employee of the corporation granting the option, or of a corporation which is at the time the option is exercised a parent or subsidiary of such corporation, unless the old option has been assumed or a new option has been issued in its place under section 421 (g). See paragraph (d) of § 1.421–4. In case of such an assumption of the old option or such issuance of a new option, the individual exercising the option must, at the time he exercises the option, be a bona fide employee of the corporation so assuming or issuing the option, or a parent or subsidiary of such corporation. Section 421 is also applicable if the individual exercising the option was a bona fide employee of any of such corporations within three months before the exercise of the option.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1954, X Corporation granted a restricted stock option to A, an employee of X Corporation, to purchase a share of X stock. On February 1, 1955, X sold the plant where A was employed to M Corporation, an unrelated corporation, and A was employed by M. If A exercises this restricted stock option on June 1, 1955, section 421 is not applicable to such exercise, because on June 1, 1955, A is not employed by the corporation which granted the option or by a parent or subsidiary of such corporation. Nor was he employed by any of such corporations within three months before June 1, 1955.

Example (2). Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated, and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation issuing an option under section 421 (g). If A exercises the option to purchase the share of M stock on June 1, 1955, section 421 is applicable for A is then employed by a corporation which issued an option under section 421 (g).

(c) (1) The determination whether an option ultimately exercised is a restricted stock option is made as of the date such option is granted. An option which is a restricted stock option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a restricted stock option when granted does not become such an option by reason of subsequent events. See, however, § 1.421–4, relating to modification, extension, or renewal of an option.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). S–1 Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 1954, P grants to an employee of P a restricted stock option to purchase a share of stock of S–1. On January 1, 1955, S sells a portion of the S–1 stock which it owns to an unrelated corporation and, as of that date, S–1 ceases to be a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. The employee has exercised a restricted stock option.

Example (2). Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1954, S–1 is not a subsidiary of either S or P. Such option is not a restricted stock option on June 1, 1954. On January 1, 1955, S purchases from an unrelated corporation a sufficient number of shares of S–1 stock to make S–1, as of that date, a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. The employee has not exercised a restricted stock option.

(d) For the rules applicable to an exercise of a restricted stock option by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (d) of § 1.421–5.

§ 1.421–4 Modification, extension, or renewal.

(a) *In general.* Section 421(e) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a restricted stock option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) in the case of an exercise of an option in any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954.

(b) *Effect of a modification, extension, or renewal.* (1) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option.

(2) Except as otherwise provided in subparagraph (3) of this paragraph, in case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for the purpose of applying the rule of section 421 (d) (1) (A)—

(i) The fair market value on the date of the original granting of the option,

(ii) The fair market value on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value at the time of the making of any intervening modification, extension, or renewal.

(3) (i) The rules of subparagraph (2) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly reflect the average fair market value of the stock for any such month.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On June 1, 1954, a restricted stock option was granted to purchase before July 1, 1955, a share of stock for $85. The fair market value of such stock on June 1, 1954, was $100. On June 15, 1955, when the fair market value of the stock is $60, such option is extended so that it is exercisable at any time before July 1, 1956, at $55 a share. The average fair market value of the stock subject to the option for each of the 12 calendar months preceding June 1955, is as follows:

1954		1955	
June	$100	January	$90
July	90	February	80
August	80	March	70
September	70	April	60
October	80	May	60
November	80		
December	90		

The aggregate of such values is $950. When this sum is divided by 12, the result is $79.17, which is an amount less than 80 percent of the fair market value of the stock ($100) when the option was granted. Accordingly, when the option is extended on June 15, 1955, the option price could have been reduced as low as $51 (85 percent of the fair market value of the stock on such day) without disqualifying the option as a restricted stock option. If the aggregate fair market values of the stock so ascertained had amounted to $960 or more, the rules of subparagraph (2) of this paragraph would have been applicable with the result that any reduction in the option price would have disqualified the option as a restricted stock option.

(c) *Definition of modification, extension, or renewal.* (1) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in paragraph (b) of § 1.421–1. For the purpose of section 421, the term "modification" means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change, which accelerates the time when the option is first exercisable, or which provides more favorable terms for the payment for the stock purchased under the option, is a modification. A mere change in the terms of the option, with respect to the number or price of the shares of stock subject to the option, to reflect a stock dividend or stock split-up is not a modification of the option. In case there is an assumption or substitution of the option by reason of certain corporate transactions, see paragraph (d) of this section. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

(2) Any change in the terms of an option for the purpose of qualifying the option as a restricted stock option grants additional benefits and, therefore, is a modification. For example, if an option was granted to purchase for $80 a share of stock, the fair market value of which was $100 at such time, and if later the option price is increased to $85 in order to meet the requirement of section 421 (d) (1) (A), such change is a modification of the option, although the price is increased. Accordingly, the option, despite the change, is not a restricted stock option if the fair market value of the share is more than $100 when the price is increased. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution, such change is not a modification, provided the option is at the same time changed so that it is not exercisable after the expiration of ten years from the date the option was granted.

(3) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(d) *Assumption or substitution of restricted stock options in connection with certain corporate transactions.* (1) Where, by reason of a corporate transaction, as defined in this paragraph, an employer corporation, or its parent or subsidiary corporation, assumes an existing option, or issues a new option in place of the old option, such assumption or issuance is not a modification, if—

(i) The excess of the aggregate fair market value of the stock subject to the option immediately after such assumption or issuance over the aggregate option price is not more than the excess of the aggregate fair market value of the stock subject to the option immediately before such assumption or issuance over the aggregate option price, and

(ii) Such assumption of the old option, or issuance of the new option, does not give the optionee additional benefits under the option.

For the purpose of this paragraph, the term "corporate transaction" means a corporate merger, consolidation, purchase or acquisition of property or stock, separation, reorganization, or liquidation. Thus, for this purpose, a "corporate transaction" includes a taxable transaction (such as, a purchase of stock or property for cash) and any corporate reorganization (whether or not it comes within the definition of such term in section 368) and any corporate liquidation (whether or not section 332 is applicable).

(2) (i) Section 421 (g) provides rules under which a new employer, or parent or subsidiary of a new employer, may by reason of a corporate transaction assume a restricted stock option granted by the former employer or parent or subsidiary thereof, or issue a new restricted stock option in place of the option granted by the former employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. For example, section 421 (g) may apply where there is a merger of X Corporation into Y Corporation and Y Corporation wishes to employ the employees of X Corporation and to assume restricted stock options which had been granted to them by their former employer, X Corporation. Another example is where X Corporation forms a new subsidiary, Y Corporation, and transfers to it certain assets and employees, and where Y Corporation wishes to grant to such employees a restricted stock option to purchase its stock in place of the restricted stock option which they had to purchase stock of X Corporation.

(ii) Section 421 (g) also provides rules under which a new parent or subsidiary corporation of the employer corporation may by reason of a corporate transaction assume a restricted stock option granted by the employer or parent or subsidiary thereof, or issue a new restricted stock option in place of the option granted by the employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. Section 421 (g) may apply, for example, where X Corporation acquires a new subsidiary, Y Corporation, by purchase of stock and desires to grant to the employees of Y Corporation a restricted stock option to buy stock of X Corporation in place of the restricted stock option which they have to purchase the stock of Y Corporation.

(iii) Section 421 (g) applies only when the assumption or substitution occurs by reason of a corporate transaction as defined in this paragraph. Thus, section 421(g) may apply where as a result of a corporate transaction a restricted stock option can no longer be exercised, or if exercised, section 421 would not apply (see the first example in subdivision (i) of this subparagraph). Moreover, section 421 (g) may apply in any case where the reason for the assumption or substitution grows out of a corporate transaction even though there could have been a valid exercise under section 421 of the original option (see the second example in subdivision (i) of this subparagraph and the example in subdivision (ii) of this subparagraph). However, a corporation which has issued an option may not substitute a new option for such option under section 421 (g).

(3) For section 421 (g) to apply, it is not necessary to show that the corporation assuming or substituting the option is under any obligation to do so. In fact, section 421 (g) may apply where the option which is being assumed or replaced expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, section 421 (g) cannot be applied to revive a restricted stock option which, for reasons not related to the corporate transaction, expires before it can properly be assumed or replaced under section 421 (g). For section 421 (g) to apply, the assumed or substituted option must qualify as a restricted stock option.

(4) Section 421 (g) does not apply if the terms of the assumed or substituted option confer on the employee more favorable benefits than he had under

the old option. Thus, section 421 (g) would not apply if the old option had just two years to run but the new option has more than two years to run.

(5) For the purpose of applying section 421 (g), the assumption or substitution shall be considered to occur at the time that the optionee would, except for section 421 (g), be considered to have been granted the option which the employer corporation, or parent or subsidiary thereof, is issuing or assuming. An assumption or substitution which occurs by reason of a corporate transaction may occur before or after the corporate transaction.

(6) In order to have a substitution of an option under section 421 (g) the optionee must, in connection with the corporate transaction, lose his rights under the old option. There cannot be a substitution of a new option for an old option within the meaning of section 421 (g) if it is contemplated that the optionee may exercise both the old option and the new option. It is not necessary, however, to have a complete substitution of a new option for the old option. For example, assume that X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and distributes the stock of Y Corporation to the shareholders of X Corporation. Assume further that E, an employee of X Corporation, is thereafter an employee of both X Corporation and Y Corporation. Y Corporation wishes to substitute an option to purchase some of its stock for the restricted stock option which employee E has entitling him to purchase 100 shares of the stock of X Corporation. The option to purchase the stock of X Corporation, at $42.50 a share, was granted when the stock had a fair market value of $50 a share, and the stock was worth $100 a share just before the distribution of the new corporation's stock to the shareholders of X Corporation. The stock of X Corporation and of Y Corporation is worth $50 a share just after such distribution, which also is the time of the substitution. On these facts an option to purchase 200 shares of stock of Y Corporation at $21.25 a share could be given to the employee in complete substitution for the old option. It would also be permissible to give the employee an option to purchase 100 shares of stock of Y Corporation at $21.25 a share in substitution for his right to purchase 50 of the shares covered by the old option.

(7) Any reasonable methods may be used to determine the fair market value of the stock subject to the option immediately before the assumption or substitution and the fair market value of the stock subject to the option immediately after the assumption or substitution. Such methods include the valuation methods described in § 20.2031–2 of this chapter (the Estate Tax Regulations). In the case of stock listed on a stock exchange, the fair market value may be based on the last sale before and the first sale after the assumption or substitution if such sales clearly reflect the fair market value of the stock, or may be based upon an average selling price during a longer period, such as the day or week before, and the day or week after, the assumption or substitution. If the stocks are not listed, or if they are newly issued, it will be reasonable to base the determination on experience over even longer periods. In the case of a merger, consolidation, or other reorganization which is arrived at by arm's length negotiations, the fair market value of the stocks subject to the option before and after the assumption or substitution may be based upon the values assigned to the stock for purposes of the reorganization. For example, if in the case of a merger the parties treat each share of the merged company as being equal in value to a share of the surviving company, it will be reasonable to assume that the stocks are of equal value so that the substituted option may permit the employee to purchase at the same price one share of the surviving company for each share he could have purchase of the merged company.

(8) For the purpose of applying section 421 (g), the determination of whether the parent-subsidiary relationship exists shall be based upon circumstances existing immediately after the corporate transaction.

(e) *Effect on qualification.* A restricted stock option may, as a result of a modification, extension, or renewal, thereafter cease to be a restricted stock option, or any option may, by modification, extension, or renewal, thereafter become a restricted stock option.

(f) *Examples.* The rule stated in section 421 (e) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $90 per share, such option to be exercised on or before June 1, 1956. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1955, before the employee exercises the option, X Corporation modifies the option to provide that the price at which the employee may purchase the stock shall be $80 per share. On February 1, 1955, the fair market value of the X Corporation stock is $90 per share. Under section 421 (e), the X Corporation is deemed to have granted an option to the employee on February 1, 1955. Unless the value of the stock has substantially declined making paragraph (b) (3) of this section applicable, such option shall be treated as an option to purchase at $80 per share 100 shares of stock having a fair market value of $100 per share, that is, the higher of the fair market value of the stock on June 1, 1954, and on February 1, 1955. The exercise of such option by the employee after February 1, 1955, is not the exercise of a restricted stock option.

Example (2). On June 1, 1954, the X Corporation grants to an employee a restricted stock option to purchase 100 shares of X Corporation stock at $90 per share, exercisable after December 31, 1955, and on or before June 1, 1956. On June 1, 1954, the fair market value of X Corporation's stock is $100 per share. On February 1, 1955, X Corporation modifies the option to provide that the option shall be exercisable on or after February 1, 1955, and on or before June 1, 1956. On February 1, 1955, the fair market value of X Corporation stock is $110 per share. Under section 421 (e), X Corporation is deemed to have granted an option to the employee on February 1, 1955, to purchase at $90 per share 100 shares of stock having a fair market value of $110 per share, that is, the higher of the fair market value of the stock on June 1, 1954, and on February 1, 1955. The exercise of such option by the employee is not the exercise of a restricted stock option.

Example (3). The facts are the same as in example (1), except that the employee exercised the option to the extent of 50 shares on January 15, 1955, before the date of the modification of the option. Any exercise of the option after February 1, 1955, the date of the modification, is not the exercise of a restricted stock option. See example (1) in this paragraph. The exercise of the option on January 15, 1955, pursuant to which 50 shares were acquired, is the exercise of a restricted stock option.

Example (4). On June 1, 1954, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $80 per share, such option to be exercised on or before June 1, 1956. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1955, before the employee exercises the option, the X Corporation modifies the option to provide that the number of shares of stock which the employee may purchase at $80 per share will be 250. On February 1, 1955, the fair market value of the X Corporation stock is $90 per share. Under these facts, the X Corporation has granted two options, one option (not a restricted stock option) with respect to 100 shares having been granted on June 1, 1954, and the other option (a restricted stock option) with respect to the additional 150 shares having been granted on February 1, 1955. In the absence of facts identifying which option is exercised first, the employee will be deemed to have exercised the options in the order in which they were granted.

§ 1.421–5 Operation of section 421.

(a) *Rules applicable to all restricted stock options*—(1) *In general.* If a share of stock is transferred to an individual pursuant to his timely exercise of a restricted stock option and is not disposed of by him within two years from the date of the granting of the option nor within six months after the transfer of such share to him, then, under section 421 (a)—

(i) No income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(ii) No deduction under section 162 shall be allowable at any time to the employer corporation of such individual or its parent or subsidiary corporation, or to a corporation which assumed or issued the option under section 421 (g), with respect to the share so transferred; and

(iii) No amount other than the option price shall be considered as received by any of such corporations for the share so transferred.

For the purpose of subdivisions (i), (ii), and (iii) of this subparagraph, each share of stock transferred pursuant to a restricted stock option is treated separately. For example, if an individual, while employed by a corporation granting him a restricted stock option, exercises the option with respect to part of the stock covered by the option, and if such individual exercises the balance of the option more than three months after leaving such employment, the application of section 421 to the stock obtained upon the earlier exercise of the option

is not affected by the fact that the income taxes of the employer and the individual with respect to the stock obtained upon the later exercise of the option are not determined under section 421.

(2) *Holding period.* The special rules provided in section 421 (a) are not applicable if the individual disposes of the share of stock within two years from the date the option is granted or within six months after the transfer of such share to him. Section 421 is not made inapplicable by a transfer within the 2-year or 6-month period if such transfer is not a disposition of the stock as defined in subparagraph (3) of this paragraph, for example, a transfer from the decedent to his estate or a transfer by bequest or inheritance. Similarly, a disposition by the executor, administrator, heir, or legatee is not a disposition by the decedent. In case a restricted stock option is exercised by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (d) of this section.

(3) *Disposition of stock.* (i) For the purpose of section 421, the term "disposition" includes a sale, exchange, gift, or any transfer of legal title, but does not include—

(*a*) A transfer from a decedent to his estate or a transfer by bequest or inheritance; or

(*b*) An exchange which occurs in a taxable year of the optionee beginning after December 31, 1953, and ending after August 16, 1954, and to which is applicable section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) or a corresponding provision of the Internal Revenue Code of 1939; or

(*c*) A mere pledge or hypothecation.

However, a disposition of the stock pursuant to a pledge or hypothecation is a disposition by the individual, even though the making of the pledge or hypothecation is not such a disposition.

(ii) If an individual exercises a restricted stock option, a share of stock acquired pursuant to such exercise is not considered disposed of by the individual if such share is taken in the name of the individual and another person jointly with right of survivorship, or is subsequently transferred into such joint ownership, or is retransferred from such joint ownership to the sole ownership of the individual. However, any termination of such joint ownership is a disposition of such share, except to the extent that the individual reacquires ownership of the share. For example, if such individual and his joint owner transfer such share to another person, the individual has made a disposition of such share. Likewise, if a share of stock held in the joint names of such individual and another person is transferred to the name of such other person, there is a disposition of such share by the individual. If an individual exercises a restricted stock option and a share of stock is transferred to another or is transferred to such individual in his name as trustee for another, the individual has made a disposition of such share.

(4) *Examples.* The rules of section 421 (a) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to E, an employee, a restricted stock option to purchase 100 shares of X Corporation stock at $95 per share. On that date, the fair market value of X Corporation stock is $100 per share. On June 1, 1955, while employed by X Corporation, E exercises the option in full and pays X Corporation $9,500, and on that day X Corporation transfers to E 100 shares of its stock having a fair market value of $12,000. Before June 1, 1956, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 1955, with respect to the transfer to him of the 100 shares of X Corporation stock. X Corporation is not entitled to any deduction at any time with respect to its transfer to E of the stock. E's basis for such 100 shares is $9,500.

Example (2). Assume, in example (1), that on August 1, 1956, two years and two months after the granting of the option and one year and two months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000, which is the fair market value of the stock on that date. For the taxable year in which the sale occurs, E realizes a gain of $3,500 ($13,000 minus E's basis of $9,500), which is treated as long-term capital gain.

Example (3). Assume, in example (2), that on August 1, 1956, E makes a gift of the 100 shares of X Corporation stock to his son. Such disposition results in no realization of gain to E either for the taxable year in which the option is exercised or the taxable year in which the gift is made. E's basis of $9,500 becomes the donee's basis for determining gain or loss.

Example (4). Assume, in example (1), that on May 1, 1956, one year and 11 months after the granting of the option and 11 months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000. The special rules of section 421 (a) are not applicable to the transfer of the stock by X Corporation to E, because disposition of the stock was made by E within two years from the date the option was granted. See paragraph (e) of this section for the effect of a disqualifying disposition.

Example (5). Assume, in example (1), that E dies on September 1, 1955, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 1955, of the restricted stock option. On the date of death, the fair market value of the stock is $12,500. No income is realized by E by reason of the transfer of the 100 shares to his estate. If the stock is valued as of the date of E's death for estate tax purposes, the basis of the 100 shares in the hands of the executor is $12,500.

(b) *Additional rules applicable where the option price is between 85 percent and 95 percent of the value of the stock*—(1) *In general.* (i) If all the conditions necessary for the application of section 421 (a) exist, section 421 (b) provides additional rules which are applicable in cases where, at the time the restricted stock option is granted, the option price per share is less than 95 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and the 6-month periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) an amount determined in the following manner. If the option qualified under section 421 (d) (1) (A) (i) (see paragraph (d) (2) (i) of § 1.421–1) such amount shall be the amount, if any, by which the option price is exceeded by the lesser of the fair market value of the share at the time the option was granted or the fair market value of the share at the time of such disposition or death. However, if the option qualified under section 421 (d) (1) (A) (ii) (see paragraph (d) (2) (ii) of § 1.421–1), such amount shall be whichever of the following amounts is lesser:

(*a*) The excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(*b*) The excess of the fair market value of the share at the time the option was granted over the option price, computed as if the option had been exercised at such time.

The amount of such compensation shall be included in the individual's gross income for the taxable year in which the disposition occurs or for the taxable year closing with his death, whichever event results in the application of section 421 (b).

(ii) The application of the special rules provided in section 421 (b) shall not affect the rules provided in section 421 (a) with respect to the individual exercising the option, the employer corporation, or its parent or subsidiary corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 421 (b), no income results to the individual at the time the stock is transferred to him, and no deduction under section 162 is allowable at any time to the employer corporation or its parent or subsidiary with respect to such amount.

(iii) If the individual exercises a restricted stock option during his lifetime and dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of section 421, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) *Basis.* If the special rules provided in section 421 (b) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 421 (b). If the special rules provided in section 421 (b) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross

income under section 421 (b). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) *Examples.* The operation of section 421 (b) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date is $100 per share. On June 1, 1955, E exercises the restricted stock option and on that date the X Corporation transfers the share of stock to E. On January 1, 1957, E sells the share for $150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporation are as follows: (i) Compensation in the amount of $15 is includible in E's gross income for 1957, the year of the disposition of the share. The $15 represents the difference between the option price ($85) and the fair market value of the share on the date the option was granted ($100), since such value is less than the fair market value of the share on the date of disposition ($150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100. Since the share was sold for $150, E realizes a gain of $50, which is treated as long-term capital gain; (ii) The X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

Example (2). Assume, in example (1), that E sells the share of X Corporation stock on January 1, 1958, for $75, its fair market value on that date. Since $75 is less than the option price ($85), no amount in respect of the sale is includible as compensation in E's gross income for 1958. E's basis for determining gain or loss on the sale is $85. Since E sold the share for $75, E realized a loss of $10 on the sale, which loss is treated as a long-term capital loss.

Example (3). Assume, in example (1), that the option provides that the option price shall be 90 percent of the fair market value of a share of the stock on the day the option is exercised. On June 1, 1955, when the option is exercised, the fair market value of the stock is $120 per share so that E pays $108 for the share of stock. Compensation in the amount of $10 is includible in E's gross income for 1957, the year of the disposition of the share. This is determined in the following manner. The excess of the fair market value of the stock at the time of the disposition ($150) over the price paid for the share ($108) is $42; and the excess of the fair market value of the stock at the time the option was granted ($100) over the option price, computed as if the option had been exercised at such time ($90), is $10. Accordingly, $10, the lesser, is includible in gross income. In this situation, E's cost basis of $108 is increased by $10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $118. Since the share was sold for $150, E realizes a gain of $32, which is treated as long-term capital gain.

Example (4). Assume, in example (1), that instead of selling the share on January 1, 1957, E makes a gift of the share on that day. In such case, $15 is includible as compensation in E's gross income for 1957. E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

Example (5). Assume, in example (2), that instead of selling the share on January 1, 1958, E makes a gift of the share on that date. Since the fair market value of the share on that day ($75) is less than the option price ($85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1958. E's basis for the share is $85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015 (a), is $75 (fair market value of the share at the date of gift).

Example (6). Assume, in example (1), that after acquiring the share of stock on June 1, 1955, E dies on August 1, 1956, at which time the share has a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death, such $15 being the difference between the option price ($85) and the fair market value of the share when the option was granted ($100), since such value is less than the fair market value at date of death ($150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (7). Assume, in example (6), that E dies on August 1, 1955, at which time the share has a fair market value of $150. Although E's death occurred within two years from the date of the granting of the option and within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

Example (8). Assume the same facts as in example (1), except that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and except that E and his wife sold the share on June 15, 1956, for $150, its fair market value on that date. Compensation in the amount of $15 is includible in E's gross income for 1956, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is $100, that is, the cost of $85 increased by the amount of $15 includible as compensation in E's gross income. The gain of $50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

Example (9). Assume the same facts as in example (1), except that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and except that E predeceased his wife on August 1, 1956, at which time the share had a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death. See example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (10). Assume, in example (9), that E's wife predeceased him on July 1, 1956. Section 421 (b) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1956, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1956 (after the death of his wife), for $150, its fair market value at that time, the income tax consequences would be the same as in example (1).

(c) *Acquisition of other stock.* (1) Section 421 (c) provides that the special rules stated in section 421 (a) and (b), if applicable with respect to stock transferred to an individual upon his exercise of an option, shall likewise be applicable with respect to stock acquired by a distribution or an exchange to which is applicable section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) or a corresponding provision of the Internal Revenue Code of 1939. Stock so acquired shall, for the purpose of section 421, be considered as having been transferred to the individual upon his exercise of the option. A similar rule shall be applied in the case of a series of such acquisitions. With respect to such acquisitions, section 421(c) does not make inapplicable any of the provisions of section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036). Section 421 (c) is applicable only with respect to such acquisitions which occur in any taxable year of the shareholder which begins after December 31, 1953, and ends after August 16, 1954. As to acquisitions occurring in earlier taxable years, see section 130A (c) of the Internal Revenue Code of 1939.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. If, with respect to stock transferred pursuant to the timely exercise of a restricted stock option, there is a distribution of new stock to which section 305 (a) is applicable, and if there is a disposition of such new stock within two years after the option was granted, such disposition makes section 421 inapplicable to the transfer of the original stock pursuant to the exercise of the option to the extent that the disposition effects a reduction of the individual's total interest in the old and new stock. However, if the new stock, as well as the old stock, is not disposed of within two years after the option was granted, nor within six months after the transfer of the old stock pursuant to the exercise of the option, section 421 is applicable.

(d) *Exercise after death.* (1) If a restricted stock option is exercised by the estate of the individual to whom the option was granted, or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual, and if such exercise occurs in a taxable year of the estate or of such person beginning after December 31, 1953, and ending after August 16, 1954, section 421 applies to such exercise in the same manner as if such option had been exercised by such deceased individual. Consequently, neither the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to such exercise of the option. Nor does section 421 become inapplicable if such executor, administrator, or person disposes of the stock so acquired within two years after the granting of such option or within six months after the transfer of the stock pursuant to the exercise of such option. This exception as to the applicability of section 421 does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss. The executor, administrator, or such person need not exercise the option within three months after the death of the individual to whom the option was granted for section 421 to be applicable. However, the exercise of the option must be pursuant to the terms of the option, and any change in the terms of the option is

subject to the rules of § 1.421–4, relating to the modification, extension, or renewal of the option. Section 421 is applicable even though such executor, administrator, or person is not employed by the corporation granting the option, or a parent or subsidiary thereof, either when the option is exercised or at any time. However, section 421 is not applicable to an exercise of the option by the estate or by such person, unless the individual to whom the option was granted met the requirements of paragraph (b) of § 1.421–3, relating to the employment of such individual, either at the time of his death or within three months before such time. If the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of such deceased individual, section 421 is not applicable to the exercise. For example, if the option is sold by the estate, section 421 does not apply to an exercise of the option by such buyer; but if the option is distributed by the administrator to an heir as part of the estate, section 421 is applicable to an exercise of the option by such heir.

(2) Any transfer by the estate, whether a sale, a distribution of assets, or otherwise, of the stock acquired by its exercise of the option under this paragraph is a disposition of the stock. Therefore, if section 421 (b) is applicable, the estate must include an amount as compensation in its gross income. Similarly, if section 421 (b) is applicable in case of an exercise of the option under this paragraph by a person who acquired the option by bequest or inheritance or by reason of the death of the individual to whom the option was granted, there must be included in the gross income of such person an amount as compensation, either when such person disposes of the stock, or when he dies owning the stock.

(3) (i) If under section 421 (b) an amount is required to be included in the gross income of the estate or of such person, the estate or such person shall be allowed a deduction as a result of the inclusion of the value of the restricted stock option in the estate of the individual to whom the option was granted. Such deduction shall be computed under section 691 (c) by treating the restricted stock option as an item of gross income in respect of a decedent under section 691 and by treating the amount required to be included in gross income under section 421 (b) as an amount included in gross income under section 691 in respect of such item of gross income. No such deduction shall be allowable with respect to any amount other than an amount includible under section 421 (b). For the rules relating to the computation of a deduction under section 691 (c), see § 1.691 (c)–1.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On June 1, 1953, E was granted a restricted stock option to purchase for $85 one share of the stock of his employer. On such day, the fair market value of such stock was $100 a share. E died on February 1, 1954, without having exercised such option. The option was, however, exercisable by his estate, and for purposes of the estate tax was valued at $30. On March 1, 1955, the estate exercised the option, and on March 15, 1955, sold for $150 the share of stock so acquired. For its taxable year including March 15, 1955, the estate is required by section 421 (b) to include in its gross income as compensation the amount of $15. During such taxable year, no amounts of income were properly paid, credited, or distributable to the beneficiaries of the estate. However, under section 421 (d) (6) (B) the estate is entitled to a deduction determined in the following manner. E's estate includes no other items of income in respect of a decedent referred to in section 691 (a), and no deductions referred to in section 691 (b), so that the value for estate tax purposes of the restricted stock option, $30, is also the net value of all items of income in respect of the decedent. The estate tax attributable to the inclusion of the restricted stock option in the estate of E is $10. Since $15, the amount includible in gross income by reason of section 421 (b), is less than the value for estate tax purposes of the option, only 15/30 of the estate tax attributable to the inclusion of the option in the estate is deductible; that is, 15/30 of $10, or $5. The estate realizes a capital gain of $50 since the $15 which is included in the gross income of the estate is added to the $85 paid for the stock in determining the basis of the stock, but the basis of the stock is not increased by reason of the inclusion of the restricted stock option in the estate (see section 1014 (d)). No deduction under section 421 (d) (6) (B) is allowable with respect to the $50 capital gain.

(e) *Disqualifying disposition.* The disposition of a share of stock, acquired by the exercise of a restricted stock option, within two years after the granting of the option or within six months after the transfer of the share pursuant to such exercise makes section 421 inapplicable to such transfer of the share. If such disqualifying disposition occurs in a taxable year of the individual which begins after December 31, 1953, and ends after August 16, 1954, the income attributable to such transfer shall be treated by the individual as income received in the taxable year in which such disposition occurs. Similarly, if such disposition occurs in a taxable year of the employer which begins after December 31, 1953, and ends after August 16, 1954, the deduction attributable to the transfer of the share of stock pursuant to the exercise of the option shall be allowable for the taxable year in which such disposition occurs. In such cases, no amount shall be treated as income, and no amount shall be allowed as a deduction, for any taxable year other than the taxable year in which occurs the disposition. However, if the stock was transferred pursuant to the exercise of the option in a taxable year other than the taxable year of the disposition, the amount of the deduction shall be determined as if the employee had been paid compensation at the time provided in paragraph (c) of § 1.421–6.

§ 1.421–6 Options to which section 421 does not apply.

(a) *Scope of section.* (1) If an employer or other person grants to an employee or other person for any reason connected with the employment of such employee an option to purchase stock of the employer or other property, and if section 421 is not applicable, then this section shall apply. This section will apply, for example, when an option is not a restricted stock option at the time it is granted (see section 421(d)(1) and § 1.421–2), or when an option is modified so that it no longer qualifies as a restricted stock option (see section 421(e) and § 1.421–4), or when there is a disqualifying disposition of stock acquired by the exercise of a restricted stock option so that section 421 does not apply. When an option is granted for any reason connected with the employment of an employee, this section applies, if section 421 does not apply, irrespective of whether the option is granted by the employer, by a parent or subsidiary of the employer, by a stockholder of any of such corporations, or by any other person, and irrespective of whether the option is granted to the employee, to a member of his family, or to any other person, and irrespective of whether the option is to purchase the stock of the employer, the stock of a parent or subsidiary of the employer, the stock of any other corporation, or to purchase any other property.

(2) This section is applicable only to options granted on or after February 26, 1945, except that this section is not applicable to—

(i) Property transferred pursuant to an option exercised before September 25, 1959, if the property is transferred subject to a restriction which has a significant effect on its value, or

(ii) Property transferred pursuant to an option granted before September 25, 1959, and exercised on or after such date, if, under the terms of the contract granting such option, the property to be transferred upon exercise of the option is to be subject to a restriction which has a significant effect on its value and if such property is actually transferred subject to such restriction.

However, if an option granted before September 25, 1959, and on or after February 26, 1945, is sold or otherwise disposed of before exercise, the provisions of this section shall be fully applicable to such disposition.

(b) *Meaning and use of certain terms.* (1) For the purpose of this section, the term "option" includes the right or privilege of an individual to purchase property from any person by virtue of an offer continuing for a stated period of time, whether or not irrevocable, to sell such property at a stated price, such individual being under no obligation to purchase.

(2) As used in this section, the terms "employee", "employment", and "employer" have reference to the legal and bona fide relationship of employer and employee. For rules applicable to the determination whether the employer-employee relationship exists, see section 3401(c) and the regulations thereunder.

(c) *Time and amount of compensation.* If there is granted an option to which this section applies, the employee in connection with whose employment the option is granted is considered to realize compensation includible in gross income under section 61 at the time and in the amount determined in accordance

with the following rules of this paragraph:

(1) Except as provided in subparagraph (2) of this paragraph, if the option is exercised by the person to whom it was granted, the employee realizes compensation at the time an unconditional right to receive the property subject to the option is acquired by such person, and the amount of such compensation is the difference between the amount payable for the property and the fair market value of the property at the time an unconditional right to receive the property is acquired. An individual has an unconditional right to receive the property subject to the option when his right to receive such property is not subject to any conditions, other than conditions that may be performed by him at any time. Thus, if an individual who has exercised an option has a right to make payment for the property at any time and to receive the property immediately after making such payment, such individual realizes compensation at the time he exercises the option. However, if an individual who has exercised an option is prevented by the terms of the option contract from making payment immediately or from receiving an immediate transfer of the property after making payment, such individual does not realize compensation at the time he exercises the option. Such individual will not realize compensation until he does acquire the right to make payment immediately and to receive an immediate transfer of the property.

(2)(i) If the option is exercised by the person to whom it was granted but, at the time an unconditional right to receive the property subject to the option is acquired by such person, such property is subject to a restriction which has a significant effect on its value, the employee realizes compensation at the time such restriction lapses or at the time the property is sold or exchanged, in an arm's length transaction, whichever occurs earlier, and the amount of such compensation is the lesser of—

(*a*) The difference between the amount paid for the property and the fair market value of the property (determined without regard to the restriction) at the time of its acquisition, or

(*b*) The difference between the amount paid for the property and either its fair market value at the time the restriction lapses or the consideration received upon the sale or exchange, whichever is applicable.

If the property is sold or exchanged in a transaction which is not at arm's length before the time the employee realizes compensation in accordance with this subdivision, any amount of gain which the employee realizes as a result of such sale or exchange is includible in gross income at the time of such sale or exchange, but the amount includible in gross income under this subdivision at the time of the expiration of the restriction or the sale or exchange at arm's length shall be reduced by the amount of gain includible in gross income as a result of the sale or exchange not at arm's length.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (*1*). On November 1, 1959, X Corporation grants to E, an employee, an option to purchase 100 shares of X Corporation stock at $10 per share. Under the terms of the option E will be subject to a binding commitment to resell the stock to X Corporation at the price he paid for it in the event that his employment terminates within 2 years after he acquires the stock, for any reason except his death. Evidence of this commitment will be stamped on the face of E's stock certificate. E exercises the option and acquires the stock at a time when the stock, determined without regard to the restriction, has a fair market value of $18 per share. Two years after he acquires the stock, at which time the stock has a fair market value of $30 per share, E is still employed by X Corporation. E realizes compensation upon the expiration of the 2-year restriction and the amount of the compensation is $800. The $800 represents the difference between the amount paid for the stock ($1,000) and the fair market value of the stock (determined without regard to the restriction) at the time of its acquisition ($1,800), since such value is less than the fair market value of the stock at the time the restriction lapsed ($3,000).

Example (*2*). Assume, in example (1), that E dies one year after he acquires the stock, at which time the stock has a fair market value of $25 per share. Since the restriction lapses upon E's death, he realizes compensation of $800 ($1,800 less $1,000) and this amount is includible in E's gross income for the taxable year closing with his death.

Example (*3*). Assume that, pursuant to the exercise of an option to which this section applies, an employee acquires stock subject to the sole condition that, if he desires to dispose of such stock during the period of his employment, he is obligated to offer to sell the stock to his employer at its fair market value at the time of such sale. Since this condition is not a restriction which has a significant effect on value, the employee realizes compensation upon acquisition of the stock.

Example (*4*). Assume, in example (3), that the employee is obligated to offer to sell the stock to his employer at its book value rather than at its fair market value. Since this condition amounts to a restriction which has a significant effect on value, the employee does not realize compensation upon acquisition of the stock, but he does realize such compensation upon the lapse of the restriction, such as, for example, his death or the termination of his employment.

(3) If the option is not exercised by the person to whom it was granted, but is transferred in an arm's length transaction, the employee realizes compensation in the amount of the gain resulting from such transfer of the option, and such compensation is includible in his gross income in accordance with his method of accounting.

(4) If the option is not exercised by the person to whom it was granted, but is transferred in a transaction which is not at arm's length, the employee realizes compensation in the amount of the gain resulting from such transfer of the option, and such compensation is includible in his gross income in accordance with his method of accounting. Moreover, the employee realizes additional compensation at the time and in the amount determined under subparagraph (1), (2), or (3) of this paragraph, except that the amount of compensation determined under subparagraph (1), (2), or (3) of this paragraph shall be reduced by any amount previously includible in gross income as a result of such transfer of the option. For example, if in 1960 an employee is granted an option to buy a share of stock for $50 at a time when the stock has a fair market value of $100, and later in 1960 the employee transfers, in a transaction not at arm's length, the option to his wife for $10, the employee realizes compensation of $10 in 1960. If in 1961 the wife exercises the option at a time when the stock has a fair market value of $120, the employee realizes additional compensation in 1961 in the amount of $60 (the $70 bargain spread less the $10 taxed as compensation in 1960). For the purpose of this subparagraph, if a person other than the employee dies holding an unexercised option at a time when the employee is still living, the transfer which results by reason of the death of such person is a transfer in a transaction which is not at arm's length.

(5) If there is granted an option to which this section applies, and the employee dies before realizing the compensation in accordance with the rules of this paragraph, income having the character of compensation is realized at the time and in the amount determined under this paragraph by the person who transfers or exercises the option, or the person who receives the property subject to a restriction which has a significant effect on its value. For example, this subparagraph is applicable when an option is granted to an employee and he dies before transferring or exercising the option, or when an option is granted to the employee and he dies after the transfer of the option in a transaction which is not at arm's length but before the option is exercised, or when an option is granted to another person and the employee dies before realizing all of the compensation which would result from any transfer or exercise of the option. If the option is one which was granted to the employee and he dies before transferring or exercising the option, the option shall be considered a right to receive income in respect of a decedent to which the rules of section 691 apply. In any such case, if the option is transferred, section 691 provides that the amount received for such transfer or the fair market value of the property transferred at the time of transfer, whichever is greater, is income realized at the time of such transfer. Moreover, if a transfer is subject to the rule of the preceding sentence, it will be treated as a transfer in an arm's length transaction for the purpose of this paragraph.

(6) If an option to which this section applies is exercised in part and transferred in part, the rules of this paragraph shall be applied as if there were two options—one exercised and one transferred.

(7) Notwithstanding the other provisions of this paragraph, if this section is applicable because of a disqualifying disposition of stock acquired by the exercise

of a restricted stock option, the taxable year of the employee for which he is required to include in his gross income the compensation resulting from such option is determined under section 421(f) and paragraph (e) of § 1.421–5.

(d) *Basis.* (1) If an option to which this section applies is exercised by the person to whom it was granted, such person's basis for the property so acquired shall be increased by any amount that is includible in the gross income of the employee under paragraph (c) of this section. If such person transfers such property to a person whose basis is the same as the transferor's basis, such transferee's basis shall also reflect the adjustment made by this paragraph. However, if such property is transferred by either of such persons at death so that its basis is determined under section 1014, the basis so determined shall not be increased by reason of this paragraph.

(2) If an option to which this section applies is transferred in a transaction which is not at arm's length, the transferee who exercises the option shall increase his basis for the property so acquired by any amount that is includible in the gross income of the employee at the time such transferee acquires such property.

(3) If an option to which this section applies is transferred in a transaction which is at arm's length, the basis of the property acquired by an exercise of the option shall not be increased by reason of any amount that is includible in the gross income of the employee under this section.

(e) *Deductions.* If the employer grants an option to which this section applies, the employer of the employee in connection with whose employment the option is granted is considered to have paid compensation to such employee at the same time and in the same amount as such employee is considered under paragraph (c) of this section to have realized compensation. The deductibility of the compensation considered so paid is determined under section 162, except that if this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a restricted stock option, the employer's taxable year for which such compensation is deductible is determined under section 421(f) and paragraph (e) of § 1.421–5.

ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

ACCOUNTING PERIODS

§ 1.441 Statutory provisions; period for computation of taxable income.

SEC. 441. *Period for computation of taxable income*—(a) *Computation of taxable income.* Taxable income shall be computed on the basis of the taxpayer's taxable year.

(b) *Taxable year.* For purposes of this subtitle, the term "taxable year" means—

(1) The taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(2) The calendar year, if subsection (g) applies; or

(3) The period for which the return is made, if a return is made for a period of less than 12 months.

(c) *Annual accounting period.* For purposes of this subtitle, the term "annual accounting period" means the annual period on the basis of which the taxpayer regularly computes his income in keeping his books.

(d) *Calendar year.* For purposes of this subtitle, the term "calendar year" means a period of 12 months ending on December 31.

(e) *Fiscal year.* For purposes of this subtitle, the term "fiscal year" means a period of 12 months ending on the last day of any month other than December. In the case of any taxpayer who has made the election provided by subsection (f), the term means the annual period (varying from 52 to 53 weeks) so elected.

(f) *Election of year consisting of 52–53 weeks*—(1) *General rule.* A taxpayer who, in keeping his books, regularly computes his income on the basis of an annual period which varies from 52 to 53 weeks and ends always on the same day of the week and ends always—

(A) On whatever date such same day of the week last occurs in a calendar month, or

(B) On whatever date such same day of the week falls which is nearest to the last day of a calendar month,

may (in accordance with the regulations prescribed under paragraph (3)) elect to compute his taxable income for purposes of this subtitle on the basis of such annual period. This paragraph shall apply to taxable years ending after the date of the enactment of this title.

(2) *Special rules for 52–53-week year*—(A) *Effective dates.* In any case in which the effective date or the applicability of any provision of this title is expressed in terms of taxable years beginning or ending with reference to a specified date which is the first or last day of a month, a taxable year described in paragraph (1) shall (except for purposes of the computation under section 21) be treated—

(i) As beginning with the first day of the calendar month beginning nearest to the first day of such taxable year, or

(ii) As ending with the last day of the calendar month ending nearest to the last day of such taxable year,

as the case may be.

(B) *Change in accounting period.* In the case of a change from or to a taxable year described in paragraph (1)—

(i) If such change results in a short period (within the meaning of section 443) of 359 days or more, or of less than 7 days, section 443 (b) (relating to alternative tax computation) shall not apply;

(ii) If such change results in a short period of less than 7 days, such short period shall, for purposes of this subtitle, be added to and deemed a part of the following taxable year; and

(iii) If such change results in a short period to which subsection (b) of section 443 applies, the taxable income for such short period shall be placed on an annual basis for purposes of such subsection by multiplying such income by 365 and dividing the result by the number of days in the short period, and the tax shall be the same part of the tax computed on the annual basis as the number of days in the short period is of 365 days.

(3) *Regulations.* The Secretary or his delegate shall prescribe such regulations as he deems necessary for the application of this subsection.

(g) *No books kept; no accounting period.* Except as provided in section 443 (relating to returns for periods of less than 12 months), the taxpayer's taxable year shall be the calendar year if—

(1) The taxpayer keeps no books;

(2) The taxpayer does not have an annual accounting period; or

(3) The taxpayer has an annual accounting period, but such period does not qualify as a fiscal year.

§ 1.441–1 Period for computation of taxable income.

(a) *Computation of taxable income.* Taxable income shall be computed and a return shall be made for a period known as the "taxable year." For rules relating to methods of accounting, the taxable year for which items of gross income are included and deductions are taken, inventories, and adjustments, see parts II and III (section 446 and following), subchapter E, chapter 1 of the Code, and the regulations thereunder.

(b) *Taxable year.* (1) The term "taxable year" means—

(i) The taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(ii) The calendar year, if section 441 (g) (relating to taxpayers who keep no books or have no accounting period) applies; or

(iii) The period for which the return is made, if the return is made under section 443 for a period of less than 12 months, referred to as a "short period."

(2) A taxable year may not cover a period of more than 12 calendar months except in the case of a 52–53-week taxable year. See § 1.441–2.

(3) A new taxpayer in his first return may adopt any taxable year which meets the requirements of section 441 and this section without obtaining prior approval. The first taxable year of a new taxpayer must be adopted on or before the time prescribed by law (not including extensions) for the filing of the return for such taxable year. However, for rules applicable to the adoption of a taxable year by a partnership, see paragraph (b)(2) of § 1.442–1, section 706(b), and paragraph (b) of § 1.706–1. For rules applicable to the taxable year of a member of an affiliated group which makes a consolidated return, see § 1.1502–14 and paragraph (d) of § 1.442–1.

(4) After a taxpayer has adopted a calendar or a fiscal year, he must use it in computing his taxable income and making his returns for all subsequent years unless prior approval is obtained from the Commissioner to make a change or unless a change is otherwise permitted under the internal revenue laws or regulations. See section 442 and § 1.442–1. For rules applicable to changes in taxable years of partners and partnerships, see also section 706 (b) and paragraph (b) of § 1.706–1.

(c) *Annual accounting period.* The term "annual accounting period" means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes his income in keeping his books.

(d) *Calendar year.* The term "calendar year" means a period of 12 months ending on December 31. A taxpayer who has not established a fiscal year must make his return on the basis of a calendar year.

(e) *Fiscal year.* (1) The term "fiscal year" means—

(i) A period of 12 months ending on the last day of any month other than December, or

(ii) The 52–53-week annual accounting period, if such period has been elected by the taxpayer.

(2) A fiscal year will be recognized only if it is established as the annual accounting period of the taxpayer and

only if the books of the taxpayer are kept in accordance with such fiscal year.

(f) *Election of year consisting of 52–53 weeks.* For rules relating to the 52–53-week taxable year, see § 1.441–2.

(g) *No books kept; no accounting period.* Except in the case of a short period under section 443, the taxpayer's taxable year shall be the calendar year if—

(1) The taxpayer keeps no books;

(2) The taxpayer does not have an annual accounting period (as defined in section 441 (c) and paragraph (c) of this section); or

(3) The taxpayer has an annual accounting period, but such period does not qualify as a fiscal year (as defined in section 441 (e) and paragraph (e) of this section).

For the purposes of subparagraph (1) of this paragraph, the keeping of books does not require that records be bound. Records which are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books. A taxpayer whose taxable year is required to be a calendar year under section 441 (g) and this paragraph may not adopt a fiscal year without obtaining prior approval from the Commissioner since such adoption is treated as a change of annual accounting period. See section 442 and paragraph (a) (2) of § 1.442–1.

§ 1.441–2 Election of year consisting of 52–53 weeks.

(a) *General rule.* Section 441(f) provides, in general, that a taxpayer may elect to compute his taxable income on the basis of a fiscal year which—

(1) Varies from 52 to 53 weeks,

(2) Ends always on the same day of the week, and

(3) Ends always on—

(i) Whatever date this same day of the week last occurs in a calendar month, or

(ii) Whatever date this same day of the week falls which is nearest to the last day of the calendar month.

For example, if the taxpayer elects a taxable year ending always on the last Saturday in November, then for the year 1956, the taxable year would end on November 24, 1956. On the other hand, if the taxpayer had elected a taxable year ending always on the Saturday nearest to the end of November, then for the year 1956, the taxable year would end on December 1, 1956. Thus, in the case of a taxable year described in subparagraph (3) (i) of this paragraph, the year will always end within the month and may end on the last day of the month, or as many as six days before the end of the month. In the case of a taxable year described in subparagraph (3) (ii) of this paragraph, the year may end on the last day of the month, or as many as three days before or three days after the last day of the month.

(b) *Application of effective dates.* (1) For the purpose of determining the effective date for the applicability of any provision of this title which is expressed in terms of taxable years beginning or ending with reference to the first or last day of a specified calendar month, including the time for filing returns and other documents, paying tax, or performing other acts, a 52–53-week taxable year is deemed to begin on the first day of the calendar month beginning nearest to the first day of the 52–53-week taxable year, and is deemed to end or close on the last day of the calendar month ending nearest to the last day of the 52–53-week taxable year, as the case may be. The preceding sentence does not apply to the computation of the tax if subparagraph (2) of this paragraph, relating to the computation under section 21 of the effect of changes in rates of tax during a taxable year, applies. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Assume that an income tax provision is applicable to taxable years beginning on or after January 1, 1957. For that purpose, a 52–53-week taxable year beginning on any day within the period December 26, 1956, to January 4, 1957, inclusive, shall be treated as beginning on January 1, 1957.

Example (2). Assume that an income tax provision requires that a return must be filed on or before the 15th day of the third month following the close of the taxable year. For that purpose, a 52–53-week taxable year ending on any day during the period May 25 to June 3, inclusive, shall be treated as ending on May 31, the last day of the month ending nearest to the last day of the taxable year, and the return, therefore, must be made on or before August 15.

(2) If a change in the rate of tax is effective during a 52–53-week taxable year (other than on the first day of such year as determined under subparagraph (1) of this paragraph), the tax for the 52–53-week taxable year shall be computed in accordance with section 21, relating to effect of changes, and the regulations thereunder. For the purpose of the computation under section 21, the determination of the number of days in the period before the change, and in the period on and after the change, is to be made without regard to the provisions of subparagraph (1) of this paragraph. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Assume a change in the rate of tax is effective for taxable years beginning after June 30, 1956. For a 52–53-week taxable year beginning on Wednesday, November 2, 1955, the tax must be computed on the basis of the old rates for the actual number of days, from November 2, 1955, to June 30, 1956, inclusive, and on the basis of the new rates for the actual number of days from July 1, 1956, to Tuesday, October 30, 1956, inclusive.

Example (2). Assume a change in the rate of tax for taxable years beginning after June 30. For this purpose, a 52–53-week taxable year beginning on any of the days from June 25 to July 4, inclusive, is treated as beginning on July 1. Therefore, no computation under section 21 will be required for such year because of the change in rate.

(c) *Adoption of or change to or from 52–53-week taxable year.* (1) A new taxpayer may adopt the 52–53-week taxable year for his first taxable year if he keeps his books and computes his income on that basis, or if he conforms his books accordingly in closing them. The taxpayer must thereafter keep his books and report his income on the basis of the 52–53-week taxable year so adopted unless prior approval for a change is obtained from the Commissioner. See subparagraph (4) of this paragraph. The taxpayer shall file with his return for his first taxable year a statement containing the information required in subparagraph (3) of this paragraph. A newly-formed partnership may adopt a 52–53-week taxable year without the permission of the Commissioner only if such a year ends either with reference to the same month in which the taxable years of all its principal partners end or with reference to the month of December. See paragraph (b) (1) of § 1.706–1.

(2) A taxpayer, including a partnership, may change to a 52–53-week taxable year without the permission of the Commissioner if the 52–53-week taxable year ends with reference to the end of the same calendar month as that in which the former taxable year ended, and if the taxpayer keeps his books and computes his income for the year of change on the basis of such 52–53-week taxable year, or if he conforms his books accordingly in closing them. The taxpayer must continue to keep his books and compute his income on the basis of such 52–53-week taxable year unless prior approval for a change is obtained. See subparagraph (4) of this paragraph. The taxpayer shall indicate his election to change to such 52–53-week taxable year by a statement filed with his return for the first taxable year for which the election is made. This statement shall contain the information required in subparagraph (3) of this paragraph.

(3) The statement referred to in subparagraphs (1) and (2) of this paragraph shall contain the following information:

(i) The calendar month with reference to which the new 52–53-week taxable year ends;

(ii) The day of the week on which the 52–53-week taxable year always will end; and

(iii) Whether the 52–53-week taxable year will always end on (*a*) the date on which such day of the week falls in the calendar month, or (*b*) on the date on which such day of the week last occurs which is nearest to the last day of such calendar month.

(4) Where a taxpayer wishes to change to a 52–53-week taxable year and, in addition, wishes to change the month with reference to which the taxable year ends, or where a taxpayer wishes to change from a 52–53-week taxable year, he must obtain prior approval from the Commissioner, as provided in section 442 and §1.442–1.

(5) If a change from or to a 52–53-week taxable year results in a short period (within the meaning of section 443) of 359 days or more, or six days or less, the tax computation under section 443 (b) shall not apply. If the short period is 359 days or more, it shall be treated as a full taxable year. If the short period is six days or less, such short period is not a separate taxable year but shall be added to and deemed a part of the following taxable year. (In the case of a change from or to a 52–53-week taxable year not involving a change of the month with reference to which the

taxable year ends, the tax computation under section 443 (b) does not apply since the short period will always be 359 days or more, or six days or less.) In the case of a short period which is more than six days, but less than 359 days, taxable income for the short period shall be placed on an annual basis for the purpose of section 443 (b) by multiplying such income by 365 and dividing the result by the number of days in the short period. In such case, the tax for the short period shall be the same part of the tax computed on such income placed on an annual basis as the number of days in the short period is of 365 days (unless section 443 (b) (2) and paragraph (b) (2) of § 1.443–1, relating to the alternative tax computation, apply). For adjustment in deduction for personal exemption, see section 443 (c) and paragraph (b) (1) (v) of § 1.443–1.

(6) The provisions of subparagraph (5) of this paragraph are illustrated by the following examples:

Example (1). A taxpayer having a fiscal year ending April 30 elects for years beginning after April 30, 1955, a 52–53-week taxable year ending on the last Saturday in April. This election involves a short period of 364 days, from May 1, 1955, to April 28, 1956, inclusive. Since this short period is 359 days or more, it is not placed on an annual basis and is treated as a full taxable year.

Example (2). Assume the same conditions as in example (1), except that the taxpayer elects for years beginning after April 30, 1955, a taxable year ending on the Tuesday nearest to April 30. This election involves a short period of three days, from May 1 to May 3, 1955. Since this short period is less than seven days, tax is not separately computed for it. This short period is added to and deemed part of the following 52-week taxable year which would otherwise begin on May 4, 1955, and end on May 1, 1956. Thus, that taxable year is deemed to begin on May 1, 1955, and end on May 1, 1956.

(d) *Computation of taxable income.* The principles of section 451, relating to the taxable year for inclusion of items of gross income, and section 461, relating to the taxable year for taking deductions, are generally applicable to 52–53-week taxable years. Thus, items of income and deductions are determined on the basis of a 52–53-week taxable year, except that such items may be determined as though the 52–53-week taxable year were a taxable year consisting of 12 calendar months if such practice is consistently followed by the taxpayer and if income is clearly reflected thereby. In the case of depreciation, unless some other practice is consistently followed, the allowance shall be determined as though the 52–53-week year were a taxable year consisting of 12 calendar months. Amortization deductions for the taxable year shall be determined as though the 52–53-week year were a taxable year consisting of 12 calendar months.

(e) *Taxable years beginning before January 1, 1954, and ending after August 16, 1954.* Pursuant to section 7851 (a) (1) (C), the regulations prescribed in this section relating to taxable years consisting of 52–53 weeks, shall also apply to taxable years beginning before January 1, 1954, and ending after August 16, 1954, which years are subject to the Internal Revenue Code of 1939.

§ 1.442 Statutory provisions; change of annual accounting period.

SEC. 442. *Change of annual accounting period.* If a taxpayer changes his annual accounting period, the new accounting period shall become the taxpayer's taxable year only if the change is approved by the Secretary or his delegate. For purposes of this subtitle, if a taxpayer to whom section 441 (g) applies adopts an annual accounting period (as defined in section 441 (c)) other than a calendar year, the taxpayer shall be treated as having changed his annual accounting period.

§ 1.442–1 Change of annual accounting period.

(a) *Manner of effecting such change.*—(1) *In general.* If a taxpayer wishes to change his annual accounting period (as defined in section 441(c)) and adopt a new taxable year (as defined in section 441(b)), he must obtain prior approval from the Commissioner by application, as provided in paragraph (b) of this section, or the change must be authorized under the Income Tax Regulations. A new taxpayer who adopts an annual accounting period as provided in section 441 and §§ 1.441–1 or 1.441–2 need not secure the permission of the Commissioner under section 442 and this section. However, see subparagraph (2) of this paragraph. For adoption of and changes to or from a 52–53-week taxable year, see section 441(f) and § 1.441–2; for adoption of and changes in the taxable years of partners and partnerships, see paragraph (b) (2) of this section, section 706 (b) and paragraph (b) of § 1.706–1; for special rules relating to certain corporations, subsidiary corporations, and newly married couples, see paragraphs (c), (d), and (e), respectively, of this section.

(2) *Taxpayers to whom section 441 (g) applies.* Section 441 (g) provides that if a taxpayer keeps no books, does not have an annual accounting period, or has an accounting period which does not meet the requirements for a fiscal year, his taxable year shall be the calendar year. If section 441 (g) applies to a taxpayer, the adoption of a fiscal year will be treated as a change in his annual accounting period under section 442. Therefore, such fiscal year can become the taxpayer's taxable year only with the approval of the Commissioner. Approval of any such change will be denied unless the taxpayer agrees in his application to establish and maintain accurate records of his taxable income for the short period involved in the change and for the fiscal year proposed. The keeping of records which adequately and clearly reflect income for the taxable year constitutes the keeping of books within the meaning of section 441 (g) and paragraph (g) of § 1.441–1.

(b) *Prior approval of the Commissioner*—(1) *In general.* In order to secure prior approval of a change of a taxpayer's annual accounting period, the taxpayer must file an application on Form 1128 with the Commissioner of Internal Revenue, Washington 25, D.C., on or before the last day of the month following the close of the short period for which a return is required to effect the change of accounting period. In general, a change of annual accounting period will be approved where the taxpayer establishes a substantial business purpose for making the change. In determining whether a taxpayer has established a substantial business purpose for making the change, consideration will be given to all the facts and circumstances relating to the change, including the tax consequences resulting therefrom. If the effect of the change is to defer a substantial portion of the taxpayer's income, or to shift a substantial portion of deductions, from one year to another so as to reduce substantially the tax liability of the taxpayer, the change will ordinarily not be approved. Further, approval will ordinarily be denied if the effect of the change is to cause a similar deferral or shifting in the case of another taxpayer, such as a partner, beneficiary, or shareholder in an electing small business corporation as defined in section 1371(b), etc., so as to reduce substantially such other taxpayer's tax liability. In addition, a change will ordinarily not be approved if the short period resulting from the change is one in which there is a net operating loss or, in the case of an electing small business corporation, if a substantial portion of the income of such corporation for the short period consists of amounts treated as long-term capital gain. Among the nontax factors that will be considered in determining whether a substantial business purpose has been established is the effect of the change on the taxpayer's annual cycle of business activity. However, even though a substantial business purpose is not established, the Commissioner in appropriate cases may permit a husband and wife to change his or her taxable year in order to secure the benefits of section 2 (relating to tax in the case of joint return). See paragraph (e) of this section for special rule for newly married couples.

(2) *Partnerships and partners.* (i) A newly-formed partnership may adopt a taxable year which is the same as the taxable year of all its principal partners (or is the same taxable year to which its principal partners who do not have such taxable year concurrently change) without securing prior approval from the Commissioner. If all its principal partners are not on the same taxable year, a newly-formed partnership may adopt a calendar year without securing prior approval from the Commissioner. If a newly-formed partnership wishes to adopt a taxable year that does not qualify under the preceding two sentences, the adoption of such year requires the prior approval of the Commissioner in accordance with section 706 (b) (1) and paragraph (b) of § 1.706–1. An existing partnership may change its taxable year without securing prior approval from the Commissioner if all its principal partners have the same taxable year to which the partnership changes, or if all its principal partners who do not have such a taxable year concurrently change to such taxable year. In any other case, an existing partnership may not change its taxable year unless it secures the prior approval

of the Commissioner in accordance with paragraph (b) (1) of this section and section 706 (b) (1) and paragraph (b) of § 1.706–1.

(ii) A partner may change his taxable year only if he secures the prior approval of the Commissioner in accordance with paragraph (b) (1) of this section.

(c) *Special rule for certain corporations.* (1) A corporation (other than a corporation to which subparagraph (4) of this paragraph applies) may change its annual accounting period without the prior approval of the Commissioner if all the conditions in subparagraph (2) of this paragraph are met, and if the corporation files a statement with the district director with whom the returns of the corporation are filed at or before the time (including extensions) for filing the return for the short period required by such change. This statement shall indicate that the corporation is changing its annual accounting period under paragraph (c) of § 1.442–1 and shall contain information indicating that all of the conditions in subparagraph (2) of this paragraph have been met.

(2) The provisions of this paragraph do not apply unless all of the following conditions are met:

(i) The corporation has not changed its annual accounting period at any time within the ten calendar years ending with the calendar year which includes the beginning of the short period required to effect the change of annual accounting period;

(ii) The short period required to effect the change of annual accounting period is not a taxable year in which the corporation has a net operating loss as defined in section 172;

(iii) The taxable income of the corporation for the short period required to effect the change of annual accounting period is, if placed on an annual basis (see paragraph (b) (1) (i) and (ii) of § 1.443–1), 80 percent or more of the taxable income of the corporation for the taxable year immediately preceding such short period; and

(iv) If a corporation had a special status (described in the following sentence) either for the short period or for the taxable year immediately preceding such short period, it must have the same special status for both the short period and such taxable year. For the purpose of the preceding sentence, special status includes only: a personal holding company, a foreign personal holding company, a corporation which is an exempt organization, a foreign corporation not engaged in trade or business within the United States, a Western Hemisphere trade corporation, and a China Trade Act corporation.

(3) If the Commissioner finds upon examination of the returns that the corporation, because of subsequent adjustments in establishing tax liability, did not in fact meet all the conditions in subparagraph (2) of this paragraph, the statement filed under subparagraph (1) of this paragraph shall be considered as a timely application for permission to change the corporation's annual accounting period to the taxable year indicated in the statement.

(4) A corporation which is an electing small business corporation (as defined in section 1371(b)) during the short period required to effect the change of annual accounting period may change its taxable year only if it secures the prior approval of the Commissioner in accordance with paragraph (b)(1) of this section. This subparagraph shall apply only if such short period ends after February 28, 1959.

(d) *Special rule for change of annual accounting period by subsidiary corporation.* A subsidiary corporation which is required to change its annual accounting period under § 1.1502–14, relating to the accounting period of an affiliated group which files a consolidated income tax return, may do so by filing Form 1128 with the district director with whom the consolidated return is filed. Such form shall be filed in accordance with that section. See also paragraph (h) of § 1.1502–13 and § 1.1502–32.

(e) *Special rule for newly married couples.* (1) A newly married husband or wife may change his or her annual accounting period in order to adopt the annual accounting period of the other spouse so that a joint return may be filed for the first or second taxable year of such spouse ending after the date of marriage, provided that the newly married husband or wife adopting the annual accounting period of the other spouse files a return for the short period required by such change on or before the 15th day of the 4th month following the close of such short period. See section 443 and the regulations thereunder. (If the due date for any such short-period return occurs before the date of marriage, the first taxable year of the other spouse ending after the date of marriage cannot be adopted under this paragraph.) The short-period return shall contain a statement that it is filed under authority of this paragraph. For a change of annual accounting period by a husband or wife which does not qualify under this subparagraph, see paragraph (b) of this section.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. H & W marry on September 25, 1956. H is on a fiscal year ending June 30, and W is on a calendar year. H wishes to change to a calendar year in order to file joint returns with W. W's first taxable year after marriage ends on December 31, 1956. H may not change to a calendar year for 1956 since, under paragraph (e) of § 1.442–1, he would have had to file a return for the short period from July 1 to December 31, 1955, by April 15, 1956. Since the date of marriage occurred subsequent to this due date, the return could not be filed under paragraph (e) of § 1.442–1. Therefore, H cannot change to a calendar year for 1956. However, H may change to a calendar year for 1957 by filing a return under paragraph (e) of § 1.442–1 by April 15, 1957, for the short period from July 1 to December 31, 1956. If H files such a return, H and W may file a joint return for calendar year 1957 (which is W's second taxable year ending after the date of marriage).

(f) *Effective date.* The provisions of this section (other than paragraphs (c) (4) and (e) thereof) are effective for any change of annual accounting period where the last day of the short period required to effect the change ends on or after March 1, 1957.

§ 1.443 Statutory provisions; returns for a period of less than 12 months.

SEC. 443. *Returns for a period of less than 12 months*—(a) *Returns for short period.* A return for a period of less than 12 months (referred to in this section as "short period") shall be made under any of the following circumstances:

(1) *Change of annual accounting period.* When the taxpayer, with the approval of the Secretary or his delegate, changes his annual accounting period. In such a case, the return shall be made for the short period beginning on the day after the close of the former taxable year and ending at the close of the day before the day designated as the first day of the new taxable year.

(2) *Taxpayer not in existence for entire taxable year.* When the taxpayer is in existence during only part of what would otherwise be his taxable year.

(3) *Termination of taxable year for jeopardy.* When the Secretary or his delegate terminates the taxpayer's taxable year under section 6851 (relating to tax in jeopardy).

(b) *Computation of tax on change of annual accounting period*—(1) *General rule.* If a return is made under paragraph (1) of subsection (a), the taxable income for the short period shall be placed on an annual basis by multiplying such income by 12 and dividing the result by the number of months in the short period. The tax shall be the same part of the tax computed on the annual basis as the number of months in the short period is of 12 months.

(2) *Exception*—(A) *Computation based on 12-month period.* If the taxpayer applies for the benefits of this paragraph and establishes the amount of his taxable income for the 12-month period described in subparagraph (B), computed as if that period were a taxable year and under the law applicable to that year, then the tax for the short period, computed under paragraph (1), shall be reduced to the greater of the following:

(i) An amount which bears the same ratio to the tax computed on the taxable income for the 12-month period as the taxable income computed on the basis of the short period bears to the taxable income for the 12-month period; or

(ii) The tax computed on the taxable income for the short period without placing the taxable income on an annual basis.

The taxpayer (other than a taxpayer to whom subparagraph (B) (ii) applies) shall compute the tax and file his return without the application of this paragraph.

(B) *12-month period.* The 12-month period referred to in subparagraph (A) shall be—

(i) The period of 12 months beginning on the first day of the short period, or

(ii) The period of 12 months ending at the close of the last day of the short period, if at the end of the 12 months referred to in clause (i) the taxpayer is not in existence or (if a corporation) has theretofore disposed of substantially all of its assets.

(C) *Application for benefits.* Application for the benefits of this paragraph shall be made in such manner and at such time as the regulations prescribed under subparagraph (D) may require; except that the time so prescribed shall not be later than the time (including extensions) for filing the return for the first taxable year which ends on or after the day which is 12 months after the first day of the short period. Such application, in case the return was filed without regard to this paragraph, shall be considered a claim for credit or refund with respect to the amount by which the tax is reduced under this paragraph.

(D) *Regulations.* The Secretary or his delegate shall prescribe such regulations as he deems necessary for the application of this paragraph.

(c) *Adjustment in deduction for personal exemption.* In the case of a taxpayer other than a corporation, if a return is made for a short period by reason of subsection (a) (1) and if the tax is not computed under subsection (b) (2), then the exemptions allowed as a deduction under section 151 (and any deduction in lieu thereof) shall be reduced to amounts which bear the same ratio to the full exemptions as the number of months in the short period bears to 12.

(d) *Cross references.* For inapplicability of subsection (b) in computing—

(1) Accumulated earnings tax, see section 536.

(2) Personal holding company tax, see section 546.

(3) Undistributed foreign personal holding company income, see section 557.

(4) The taxable income of a regulated investment company, see section 852 (b) (2) (E).

§ 1.443–1 Returns for periods of less than 12 months.

(a) *Returns for short period.* A return for a short period, that is, for a taxable year consisting of a period of less than 12 months, shall be made under any of the following circumstances:

(1) *Change of annual accounting period.* In the case of a change in the annual accounting period of a taxpayer, a separate return must be filed for the short period of less than 12 months beginning with the day following the close of the old taxable year and ending with the day preceding the first day of the new taxable year. However, such a return is not required for a short period of six days or less, or 359 days or more, resulting from a change from or to a 52–53-week taxable year. See section 441 (f) and § 1.441–2. The computation of the tax for a short period required to effect a change of annual accounting period is described in paragraph (b) of this section. In general, a return for a short period resulting from a change of annual accounting period shall be filed and the tax paid within the time prescribed for filing a return for a taxable year of 12 months ending on the last day of the short period. For a subsidiary corporation required to change its annual accounting period under § 1.1502–14, see §§ 1.1502–13, 1.1502–32, and paragraph (d) of § 1.442–1.

(2) *Taxpayer not in existence for entire taxable year.* If a taxpayer is not in existence for the entire taxable year, a return is required for the short period during which the taxpayer was in existence. For example, a corporation organized on August 1 and adopting the calendar year as its annual accounting period is required to file a return for the short period from August 1 to December 31, and returns for each calendar year thereafter. Similarly, a dissolving corporation which files its returns for the calendar year is required to file a return for the short period from January 1 to the date it goes out of existence. Income for the short period is not required to be annualized if the taxpayer is not in existence for the entire taxable year, and, in the case of a taxpayer other than a corporation, the deduction under section 151 for personal exemptions (or deductions in lieu thereof) need not be reduced under section 443 (c). In general, the requirements with respect to the filing of returns and the payment of tax for a short period where the taxpayer has not been in existence for the entire taxable year are the same as for the filing of a return and the payment of tax for a taxable year of 12 months ending on the last day of the short period. Although the return of a decedent is a return for the short period beginning with the first day of his last taxable year and ending with the date of his death, the filing of a return and the payment of tax for a decedent may be made as though the decedent had lived throughout his last taxable year.

(3) *Termination of taxable year for jeopardy.* A return must be filed for a short period resulting from the termination by the Commissioner of a taxpayer's taxable year for jeopardy. See section 6851 and the regulations thereunder.

(b) *Computation of tax for short period on change of annual accounting period*—(1) *General rule.* (i) If a return is made for a short period resulting from a change of annual accounting period, the taxable income for the short period shall be placed on an annual basis by multiplying such income by 12 and dividing the result by the number of months in the short period. Unless section 443 (b) (2) and subparagraph (2) of this paragraph apply, the tax for the short period shall be the same part of the tax computed on the annual basis as the number of months in the short period is of 12 months.

(ii) If a return is made for a short period of more than 6 days, but less than 359 days, resulting from a change from or to a 52–53-week taxable year, the taxable income for the short period shall be annualized and the tax computed on a daily basis, as provided in section 441 (f) (2) (B) (iii) and paragraph (c) (5) of § 1.441–2.

(iii) For method of computation of income for a short period in the case of a subsidiary corporation required to change its annual accounting period to conform to that of its parent, see §§ 1.1502–32 and 1.1502–14.

(iv) An individual taxpayer making a return for a short period resulting from a change of annual accounting period is not allowed to take the standard deduction provided in section 141 in computing his taxable income for the short period. See section 142 (b) (3).

(v) In computing the taxable income of a taxpayer other than a corporation for a short period (which income is to be annualized in order to determine the tax under section 443 (b) (1)) the personal exemptions allowed individuals under section 151 (and any deductions allowed other taxpayers in lieu thereof, such as the deduction under section 642 (b)) shall be reduced to an amount which bears the same ratio to the full amount of the exemptions as the number of months in the short period bears to 12. In the case of the taxable income for a short period resulting from a change from or to a 52–53-week taxable year to which section 441 (f) (2) (B) (iii) applies, the computation required by the preceding sentence shall be made on a daily basis, that is, the deduction for personal exemptions (or any deduction in lieu thereof) shall be reduced to an amount which bears the same ratio to the full deduction as the number of days in the short period bears to 365.

(vi) If the amount of a credit against the tax (for example, the credits allowable under sections 34 and 35 for dividends received and for partially tax-exempt interest, respectively) is dependent upon the amount of any item of income or deduction, such credit shall be computed upon the amount of the item annualized separately in accordance with the foregoing rules. The credit so computed shall be treated as a credit against the tax computed on the basis of the annualized taxable income. In any case in which a limitation on the amount of a credit is based upon taxable income, taxable income shall mean the taxable income computed on the annualized basis.

(vii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A taxpayer with one dependent who has been granted permission under section 442 to change his annual accounting period files a return for the short period of 10 months ending October 31, 1956. He has income and deductions as follows:

Income		
Interest income		$10,000.00
Partially tax-exempt interest with respect to which a credit is allowable under section 35		500.00
Dividends to which sections 34 and 116 are applicable		750.00
		11,250.00
Deductions		
Real estate taxes		200.00
2 personal exemptions at $600 on an annual basis		1,200.00
The tax for the 10-month period is computed as follows:		
Total income as above		11,250.00
Less:		
Exclusion for dividends received	$50.00	
2 personal exemptions ($1,200 × 10/12)	1,000.00	
Real estate taxes	200.00	
		1,250.00
Taxable income for 10-month period before annualizing		10,000.00
Taxable income annualized (10,000 × 12/10)		12,000.00
Tax on $12,000 before credits		3,400.00

Deductions—Continued

Deduct credits:		
Dividends received for 10-month period	$750.00	
Less: Excluded portion	50.00	
Included in gross income	700.00	
Dividend income annualized ($700×12/10)	840.00	
Credit (4 percent of $840)		$33.60
Partially tax-exempt interest included in gross income for 10-month period	500.00	
Partially tax-exempt interest (annualized) ($500×12/10)	600.00	
Credit (3 percent of $600)		18.00
		$51.60
Tax on $12,000 (after credits)		3,348.40
Tax for 10-month period ($3,348.40×10/12)		2,790.33

Example (2). The X Corporation makes a return for the one-month period ending September 30, 1956, because of a change in annual accounting period permitted under section 442. Income and expenses for the short period are as follows:

Gross operating income	$126,000
Business expenses	130,000
Net loss from operations	(4,000)
Dividends received from taxable domestic corporations	30,000
Gross income for short period before annualizing	26,000
Dividends received deduction (85 percent of $30,000, but not in excess of 85 percent of $26,000)	22,100
Taxable income for short period before annualizing	3,900
Taxable income annualized ($3,900×12)	46,800
Tax on annual basis:	
$46,800 at 52 percent	$24,336
Less surtax exemption	5,500
	18,836
Tax for 1-month period ($18,836×1/12)	1,570

Example (3). The Y Corporation makes a return for the six-month period ending June 30, 1957, because of a change in annual accounting period permitted under section 442. Income for the short period is as follows:

Taxable income exclusive of net long-term capital gain	$40,000
Net long-term capital gain	10,000
Taxable income for short period before annualizing	50,000
Taxable income annualized ($50,000×12/6)	100,000
Regular tax computation	
Taxable income annualized	100,000
Tax on annual basis:	
$100,000 at 52 percent	$52,000
Less surtax exemption	5,500
	46,500
Tax for 6-month period ($46,500×6/12)	23,250
Alternative tax computation	
Taxable income annualized	$100,000
Less annualized capital gain ($10,000×12/6)	20,000
Annualized taxable income subject to partial tax	80,000
Partial tax on annual basis	
$80,000 at 52 percent	$41,600
Less surtax exemption	5,500
	$36,100
25 percent of annualized capital gain ($20,000)	5,000
Alternative tax on annual basis	41,100
Alternative tax for 6-month period ($41,100×6/12)	20,550

Since the alternative tax of $20,550 is less than the tax computed in the regular manner ($23,250), the corporation's tax for the 6-month short period is $20,550.

(2) *Exception: computation based on 12-month period.* (i) A taxpayer whose tax would otherwise be computed under section 443 (b) (1) (or section 441 (f) (2) (B) (iii) in the case of certain changes from or to a 52–53-week taxable year) for the short period resulting from a change of annual accounting period may apply to the district director to have his tax computed under the provisions of section 443 (b) (2) and this subparagraph. If such application is made, as provided in subdivision (v) of this subparagraph, and if the taxpayer establishes the amount of his taxable income for the 12-month period described in subdivision (ii) of this subparagraph, then the tax for the short period shall be the greater of the following—

(*a*) An amount which bears the same ratio to the tax computed on the taxable income which the taxpayer has established for the 12-month period as the taxable income computed on the basis of the short period bears to the taxable income for such 12-month period; or

(*b*) The tax computed on the taxable income for the short period without placing the taxable income on an annual basis.

However, if the tax computed under section 443 (b) (2) and this subparagraph is not less than the tax for the short period computed under section 443 (b) (1) (or section 441 (f) (2) (B) (iii) in the case of certain changes from or to a 52–53-week taxable year), then section 443 (b) (2) and this subparagraph do not apply.

(ii) The term "12-month period" referred to in subdivision (i) of this subparagraph means the 12-month period beginning on the first day of the short period. However, if the taxpayer is not in existence at the end of such 12-month period, or if the taxpayer is a corporation which has disposed of substantially all of its assets before the end of such 12-month period, the term "12-month period" means the 12-month period ending at the close of the last day of the short period. For the purposes of the preceding sentence, a corporation which has ceased business and distributed so much of the assets used in its business that it cannot resume its customary operations with the remaining assets, will be considered to have disposed of substantially all of its assets. In the case of a change from a 52–53-week taxable year, the term "12-month period" means the period of 52 or 53 weeks (depending on the taxpayer's 52–53-week taxable year) beginning on the first day of the short period.

(iii) (*a*) The taxable income for the 12-month period is computed under the same provisions of law as are applicable to the short period and is computed as if the 12-month period were an actual annual accounting period of the taxpayer. All items which fall in such 12-month period must be included even if they are extraordinary in amount or of an unusual nature. If the taxpayer is a member of a partnership, his taxable income for the 12-month period shall include his distributive share of partnership income for any taxable year of the partnership ending within or with such 12-month period, but no amount shall be included with respect to a taxable year of the partnership ending before or after such 12-month period. If any other item partially applicable to such 12-month period can be determined only at the end of a taxable year which includes only part of the 12-month period, the taxpayer, subject to review by the Commissioner, shall apportion such item to the 12-month period in such manner as will most clearly reflect income for the 12-month period.

(*b*) In the case of a taxpayer permitted or required to use inventories, the cost of goods sold during a part of the 12-month period included in a taxable year shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for such part of the 12-month period is of the gross receipts from sales for the entire taxable year. For example, the 12-month period of a corporation engaged in the sale of merchandise, which has a short period from January 1, 1956, to September 30, 1956, is the calendar year 1956. The three-month period, October 1, 1956, to December 31, 1956, is part of the taxpayer's taxable year ending September 30, 1957. The cost of goods sold during the three-month period, October 1, 1956, to December 31, 1956, is such part of the cost of goods sold during the entire fiscal year ending September 30, 1957, as the gross receipts from sales for such three-month period are of the gross receipts from sales for the entire fiscal year.

(*c*) The Commissioner may, in granting permission to a taxpayer to change his annual accounting period, require, as a condition to permitting the change, that the taxpayer must take a closing inventory upon the last day of the 12-month period if he wishes to obtain the benefits of section 443 (b) (2). Such closing inventory will be used only for the purposes of section 443 (b) (2), and the taxpayer will not be required to use such inventory in computing the taxable income for the taxable year in which such inventory is taken.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). The taxpayer in example (1) under paragraph (b) (1) (vii) of this section establishes his taxable income for the 12-month period from January 1, 1956, to December 31, 1956. The taxpayer has a short period of 10 months, from January 1, 1956, to October 31, 1956. The taxpayer files an application in accordance with subdivision

(v) of this subparagraph to compute his tax under section 443(b)(2). The taxpayer's income and deductions for the 12-month period, as so established, follow:

Income

Interest income	$11,000
Partially tax-exempt interest with respect to which a credit is allowable under section 35	600
Dividends to which sections 34 and 116 are applicable	850
	12,450

Deductions

Real estate taxes		200
2 personal exemptions at $600		1,200
Tax computation for short period under section 443 (b) (2) (A) (i)		
Total income as above		$12,450
Less:		
Exclusion for dividends received	$50	
Personal exemptions	1,200	
Deduction for taxes	200	
		1,450
Taxable income for 12-month period		11,000
Tax before credits		3,020
Credit for partially tax-exempt interest (3 percent of $600)	$18	
Credit for dividends received (4 percent of ($850−50))	32	
		50
Tax under section 443 (b) (2) (A) (i) for 12-month period		2,970
Taxable income for 10-month short period from example (1) of paragraph (b)(1)(vii) of this section before annualizing		10,000
Tax for short period under section 443 (b) (2) (A) (i) ($2,970×$10,000 (taxable income for short period)/$11,000 (taxable income for 12-month period))		2,700
Tax computation for short period under section 443 (b) (2) (A) (ii)		
Total income for 10-month short period		$11,250
Less:		
Exclusion for dividends received	$50	
2 personal exemptions	1,200	
Real estate taxes	200	
		1,450
Taxable income for short period without annualizing and without proration of personal exemptions		9,800
Tax before credits		2,572
Less credits:		
Partially tax-exempt interest (3 percent of $500)	$15	
Dividends received (4 percent of ($750−50))	28	
		$43
Tax for short period under section 443 (b) (2) (A) (ii)		2,529

The tax of $2,700 computed under section 443 (b) (2) (A) (i) is greater than the tax of $2,529, computed under section 443 (b) (2) (A) (ii), and is, therefore, the tax under section 443 (b) (2). Since the tax of $2,700 (computed under section 443 (b) (2)) is less than the tax of $2,790.33 (computed under section 443 (b) (1)) on the annualized income of the short period (see example (1) of paragraph (b)(1)(vii) of this section), the taxpayer's tax for the 10-month short period is $2,700.

Example (2). Assume the same facts as in example (1) of this subdivision, except that, during the month of November 1956, the taxpayer suffered a casualty loss of $5,000. The tax computation for the short period under section 443 (b) (2) would be as follows:

Tax computation for short period under section 443 (b) (2) (A) (i)

Taxable income for 12-month period from example (1)		$11,000
Less: Casualty loss		5,000
Taxable income for 12-month period		6,000
Tax before credits	$1,360	
Credits from example (1)	50	
Tax under section 443 (b) (2) (A) (i) for 12-month period		1,310
Tax for short period ($1,310×$10,000/$6,000) under section 443 (b) (2) (A) (i)		2,183
Tax computation for short period under section 443 (b) (2) (A) (ii)		
Total income for the short period		$11,250
Less:		
Exclusion for dividends received	$50	
2 personal exemptions	1,200	
Real estate taxes	200	
		1,450
Taxable income for short period without annualizing and without proration of personal exemptions		9,800
Tax before credits		2,572
Less credits:		
Partially tax-exempt interest (3 percent of $500)	$15	
Dividends received (4 percent of $750 −50))	28	
		43
Tax for short period under section 443 (b) (2) (A) (ii)		2,529

The tax of $2,529, computed under section 443 (b) (2) (A) (ii) is greater than the tax of $2,183 computed under section 443 (b) (2) (A) (i) and is, therefore, the tax under section 443 (b) (2). Since this tax is less than the tax of $2,790.33, computed under section 443 (b) (1) (see example (1) of paragraph (b)(1)(vii) of this section), the taxpayer's tax for the 10-month short period is $2,529.

(v) (*a*) A taxpayer who wishes to compute his tax for a short period resulting from a change of annual accounting period under section 443 (b) (2) must make an application therefor. Except as provided in (*b*) of this subdivision, the taxpayer shall first file his return for the short period and compute his tax under section 443 (b) (1). The application for the benefits of section 443 (b) (2) shall subsequently be made in the form of a claim for credit or refund. The claim shall set forth the computation of the taxable income and the tax thereon for the 12-month period and must be filed not later than the time (including extensions) prescribed for filing the return for the taxpayer's first taxable year which ends on or after the day which is 12 months after the beginning of the short period. For example, assume that a taxpayer changes his annual accounting period from the calendar year to a fiscal year ending September 30, and files a return for the short period from January 1, 1956, to September 30, 1956. His application for the benefits of section 443 (b) (2) must be filed not later than the time prescribed for filing his return for his first taxable year which ends on or after the last day of December 1956, the twelfth month after the beginning of the short period. Thus, the taxpayer must file his application not later than the time prescribed for filing the return for his fiscal year ending September 30, 1957. If he obtains an extension of time for filing the return for such fiscal year, he may file his application during the period of such extension. If the district director determines that the taxpayer has established the amount of his taxable income for the 12-month period, any excess of the tax paid for the short period over the tax computed under section 443 (b) (2) will be credited or refunded to the taxpayer in the same manner as in the case of an overpayment.

(*b*) If at the time the return for the short period is filed, the taxpayer is able to determine that the 12-month period ending with the close of the short period (see section 443 (b) (2) (B) (ii) and subparagraph (2) (ii) of this paragraph) will be used in the computations under section 443 (b) (2), then the tax on the return for the short period may be determined under the provisions of section 443 (b) (2). In such case, a return covering the 12-month period shall be attached to the return for the short period as a part thereof, and the return and attachment will then be considered as an application for the benefits of section 443 (b) (2).

(c) *Adjustment in deduction for personal exemption.* For adjustment in the deduction for personal exemptions in computing the tax for a short period resulting from a change of annual accounting period under section 443 (b) (1) (or under section 441 (f) (2) (B) (iii) in the case of certain changes from or to a 52–53-week taxable year), see paragraph (b) (1) (v) of this section.

(d) *Cross references.* For inapplicability of section 443 (b) and paragraph (b) of this section in computing—

(1) Accumulated earnings tax, see section 536 and the regulations thereunder;

(2) Personal holding company tax, see section 546 and the regulations thereunder;

(3) Undistributed foreign personal holding company income, see section 557 and the regulations thereunder; and

(4) The taxable income of a regulated investment company, see section 852(b)(2)(E) and the regulations thereunder.

METHODS OF ACCOUNTING

METHODS OF ACCOUNTING IN GENERAL

§ 1.446 Statutory provisions; general rule for methods of accounting.

SEC. 446. *General rule for methods of accounting*—(a) *General rule.* Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.* If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) *Permissible methods.* Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) The cash receipts and disbursements method;
(2) An accrual method;
(3) Any other method permitted by this chapter; or
(4) Any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) *Taxpayer engaged in more than one business.* A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) *Requirement respecting change of accounting method.* Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

§ 1.446–1 General rule for methods of accounting.

(a) *General rule.* (1) Section 446 (a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446 (e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see sections 471 and 472, and the regulations thereunder.)

(ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

(iii) In any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, or depletion, any expenditures (other than ordinary repairs) made to restore the asset or prolong its useful life shall be added to the asset account or charged against the appropriate reserve.

(b) *Exceptions.* (1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(2) A taxpayer whose sole source of income is wages need not keep formal books in order to have an accounting method. Tax returns, copies thereof, or other records may be sufficient to establish the use of the method of accounting used in the preparation of the taxpayer's income tax returns.

(c) *Permissible methods*—(1) *In general.* Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method.* Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451–2. For treatment of an expenditure attributable to more than one taxable year, see section 461 (a) and paragraph (a) (1) of § 1.461–1.

(ii) *Accrual method.* Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. Likewise, the extent to which indirect costs shall be included in computing cost of goods sold depends upon the method used by the taxpayer in treating such items in keeping his books.

(iii) *Other permissible methods.* Special methods of accounting are described elsewhere in chapter 1 of the Code and the regulations thereunder. For example, see the following sections and the regulations thereunder: Sections 61 and 162, relating to the crop method of accounting; section 453, relating to the installment method; section 451, relating to the long-term contract methods. In addition, special methods of accounting for particular items of income and expense are provided under other sections of chapter 1. For example, see section 174, relating to research and experimental expenditures, and section 175, relating to soil and water conservation expenditures.

(iv) *Combinations of the foregoing methods.* (*a*) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

(b) A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

(2) *Special rules.* (i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

(ii) No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the regulations in this part if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. See section 446 (a) and paragraph (a) of this section, which require that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books, and section 446 (e) and paragraph (e) of this section, which require the prior approval of the Commissioner in the case of changes in accounting method.

(d) *Taxpayer engaged in more than one business.* (1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

(e) *Requirement respecting the adoption or change of accounting method.* (1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446 (c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446 (d) and paragraph (d) of this section. See also section 446 (a) and paragraph (a) of this section.

(2) (i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

(ii) Examples of changes requiring consent are: A change from the cash receipts and disbursements method to an accrual method, or vice versa; a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder); a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451–3); a change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income, such as the crop method; or a change in the treatment of any other items of income or expense, where material.

(3) In order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application by letter with the Commissioner of Internal Revenue, Washington 25, D. C., within 90 days after the beginning of the taxable year in which it is desired to make the change. The application shall be accompanied by a statement specifying the nature of the taxpayer's business, his present method of accounting, the method to which he desires to change, the taxable year in which the change is to be effected, the classes of items which would be treated differently under the new method, and all amounts which would be duplicated or omitted as a result of the proposed change. The Commissioner may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected. See section 481 and regulations thereunder, relating to certain adjustments required by such changes, section 472 and the regulations thereunder, relating to changes to and from the last-in, first-out method of inventorying goods, and section 453 and the regulations thereunder, relating to certain adjustments required by a change from an accrual method to the installment method.

TAXABLE YEAR FOR WHICH ITEMS OF GROSS INCOME INCLUDED

§ 1.451 Statutory provisions; general rule for taxable year of inclusion.

SEC. 451. *General rule for taxable year of inclusion*—(a) *General rule.* The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

(b) *Special rule in case of death.* In the case of the death of a taxpayer whose taxable income is computed under an accrual method of accounting, any amount accrued only by reason of the death of the taxpayer shall not be included in computing taxable income for the period in which falls the date of the taxpayer's death.

§ 1.451–1 General rule for taxable year of inclusion.

(a) *General rule.* Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section

706(a) and paragraph (a) of § 1.706–1. If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

(b) *Special rule in case of death.* (1) A taxpayer's taxable year ends on the date of his death. See section 443 (a) (2) and paragraph (a) (2) of § 1.443–1. In computing taxable income for such year, there shall be included only amounts properly includible under the method of accounting used by the taxpayer. However, if the taxpayer used an accrual method of accounting, amounts accrued only by reason of his death shall not be included in computing taxable income for such year. If the taxpayer uses no regular accounting method, only amounts actually or constructively received during such year shall be included. (For rules relating to the inclusion of partnership income in the return of a decedent partner, see subchapter K, chapter 1 of the Code, and the regulations thereunder.)

(2) If the decedent owned an installment obligation the income from which was taxable to him under section 453, no income is required to be reported in the return of the decedent by reason of the transmission at death of such obligation. See section 453 (d) (3). For the treatment of installment obligations acquired by the decedent's estate or by any person by bequest, devise, or inheritance from the decedent, see section 691 (a) (4) and the regulations thereunder.

§ 1.451–2 Constructive receipt of income.

(a) *General rule.* Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account or set apart for him so that he may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

(b) *Examples of constructive receipt.* Interest coupons which have matured and are payable but which have not been cashed are constructively received in the taxable year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year. Dividends on corporate stock are constructively received when unqualifiedly made subject to the demand of the shareholder. However, if a dividend is declared payable on December 31 and the corporation followed its usual practice of paying the dividends by checks mailed so that the shareholders would not receive them until January of the following year, such dividends are not considered to have been constructively received until January. Interest on savings bank deposits is income to the depositor when credited on the books of the bank, even though the bank has a rule, seldom or never enforced, that it may require a certain number of days' notice before withdrawals are permitted. Generally, the amount of dividends or interest credited to shareholders of organizations such as building and loan associations or cooperative banks, is income to the shareholders for the taxable year when credited. However, if the amount of such dividends or interest is not available for the shareholders' free and unrestricted use at the time credited, such amount is not constructively received and does not constitute income to the shareholder until the taxable year in which the amount is available. Accordingly, if the amount of dividends or interest is accumulated and is not available to the shareholder until the maturity of a share, the crediting thereof to the shareholder's account does not constitute constructive receipt. However, in such a case the total amount credited is income to the shareholder in the year of maturity.

§ 1.451–3 Long-term contracts.

(a) *Definition.* The term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted.

(b) *Methods.* Income from long-term contracts (as defined in paragraph (a) of this section), determined in a manner consistent with the nature and terms of the contract, may be included in gross income in accordance with one of the following methods, provided such method clearly reflects income:

(1) *Percentage of completion method.* Gross income derived from long-term contracts may be reported according to the percentage of completion method. Under this method, the portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year shall be included in gross income for such taxable year. There shall then be deducted all expenditures made during the taxable year in connection with the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable year for use in such contract. Certificates of architects or engineers showing the percentage of completion of each contract during the taxable year shall be available at the principal place of business of the taxpayer for inspection in connection with an examination of the income tax return.

(2) *Completed contract method.* Gross income derived from long-term contracts may be reported for the taxable year in which the contract is finally completed and accepted. Under this method, there shall be deducted from gross income for such year all expenses which are properly allocable to the contract, taking into account any material and supplies charged to the contract but remaining on hand at the time of completion.

(c) *In general.* Long-term contract methods of accounting apply only to the accounting for income and expenses attributable to long-term contracts. Other income and expense items, such as investment income or expenses not attributable to such contracts, shall be accounted for under a proper method of accounting. See section 446 (c) and paragraph (c) of § 1.446–1. A taxpayer may change to or from a long-term contract method of accounting only with the consent of the Commissioner. See section 446 (e) and paragraph (e) of § 1.446–1. When a taxpayer reports income under a long-term contract method, a statement to that effect shall be attached to his income tax return.

§ 1.451–4 Accounting for redemption of trading stamps and coupons.

(a) If a taxpayer issues trading stamps or premium coupons with sales, which stamps or coupons are redeemable in merchandise or cash, he should, in computing the income from such sales, subtract only the amount which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light of the experience of the taxpayer in his particular business and of other users of trading stamps or premium coupons engaged in similar businesses. The taxpayer shall file a statement showing with respect to each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, the following:

(1) The total issue of stamps or coupons during each year;

(2) The total stamps or coupons redeemed in each year; and

(3) Such other information as is necessary to establish the correctness of the amount subtracted from sales in each of such years.

(b) Upon examination of the return, the amount subtracted in respect of such coupons will be adjusted if, in the opinion of the Commissioner, such amount is incorrectly computed.

§ 1.452 Statutory provisions; prepaid income.

SEC. 452. *Prepaid income*—(a) *Prepaid income to be earned over short or indefinite period*—(1) *Short period.* In the case of any prepaid income to which this section applies, if the liability described in subsection (e) (2) is (at the time the income is received) to end before the first day of the sixth taxable year after the taxable year in which such income is received, then such income shall be included in gross income for the taxable year in which received, and for each of the 5 succeeding taxable years, to the extent proper under the method of accounting used under section 446 in computing taxable income for such year. If the liability does not in fact end before the first day of such sixth taxable year, such income shall be included in gross income for the taxable years specified in the preceding sentence except that with the consent of the Secretary or his delegate it shall be included in gross income in such pro-

portions, and for such taxable years, as are specified in such consent.

(2) *Indefinite period.* In the case of any prepaid income to which this section applies, if the liability described in subsection (e) (2) is (at the time the income is received) of indefinite duration, then such income shall be included in gross income for the taxable year in which received and for each of the 5 succeeding taxable years, consistently with the principles prescribed in paragraph (1) and subsection (b) under regulations prescribed by the Secretary or his delegate. With the consent of the Secretary or his delegate the prepaid income shall be included in gross income in such proportions, and for such taxable years, as are specified in such consent.

(b) *Prepaid income to be earned over long period.* In the case of any prepaid income to which this section applies, if the liability described in subsection (e) (2) is (at the time the income is received) to end after the close of the fifth taxable year after the taxable year in which such income is received, then—

(1) One-sixth of the prepaid income shall be included in gross income for the taxable year in which received, and one-sixth shall be included in gross income for each of the 5 succeeding taxable years; except that

(2) With the consent of the Secretary or his delegate, the prepaid income shall be included in gross income in such proportions, and for such taxable years, as are specified in such consent.

(c) *Where taxpayer's liability ceases.* In the case of any prepaid income to which this section applies—

(1) If the liability described in subsection (e) (2) ends, then so much of such income as was not includible in gross income under subsections (a) and (b) for preceding taxable years shall be included in gross income for the taxable year in which the liability ends.

(2) If the taxpayer dies or ceases to exist, then so much of such income as was not includible in gross income under subsections (a) and (b) for preceding taxable years shall be included in gross income for the taxable year in which such death, or such cessation of existence, occurs.

(d) *Prepaid income to which this section applies*—(1) *Election of benefits.* This section shall apply to prepaid income if and only if the taxpayer makes an election under this section with respect to the trade or business in connection with which such income is received. The election shall be made in such manner as the Secretary or his delegate may by regulations prescribe. No election may be made with respect to a trade or business if in computing taxable income the cash receipts and disbursements method of accounting is used with respect to such trade or business.

(2) *Scope of election.* An election made under this section shall apply to all prepaid income received in connection with the trade or business with respect to which the taxpayer has made the election; except that the taxpayer may, to the extent permitted under regulations prescribed by the Secretary or his delegate, include in gross income for the taxable year of receipt the entire amount of any prepaid income if the liability from which it arose is to end within 12 months after the date of receipt. An election made under this section shall not apply to any prepaid income received before the first taxable year for which the election is made.

(3) *When election may be made*—(A) *Without consent.* A taxpayer may, without the consent of the Secretary or his delegate, make an election under this section for his first taxable year (i) which begins after December 31, 1953, and ends after the date on which this title is enacted, and (ii) in which he receives prepaid income in the trade or business. Such an election shall be made not later than the time prescribed by this subtitle for filing the return for such year (including extensions thereof).

(B) *With consent.* A taxpayer may, with the consent of the Secretary or his delegate, make an election under this section at any time.

(e) *Definitions.* For purposes of this section—

(1) *Prepaid income.* The term "prepaid income" means any amount (includible in gross income) which is received in connection with, and is directly attributable to, a liability which extends beyond the close of the taxable year in which such amount is received. Such term does not include any income treated as gain from the sale or other disposition of a capital asset.

(2) *Liability to render services, etc.* The term "liability" means a liability to render services, furnish goods or other property, or allow the use of property.

(3) *Receipt of prepaid income.* Prepaid income shall be treated as received during the taxable year for which it is includible in gross income under section 451 (without regard to this section).

[Sec. 452 repealed by Act of June 15, 1955 (Pub. Law 74, 84th Cong., 69 Stat. 134). For regulations under Pub. Law 74, see §§ 1.9000–1 through 1.9000–8.] [1]

§ 1.452–1 Prepaid income in general.

(a) Prepaid income, regardless of the method of accounting used by the taxpayer, is generally includible in gross income by the taxpayer at the time of receipt if it is subject to his free and unrestricted use. However, in the case of a taxpayer who uses a method of accounting other than the cash receipts and disbursements method in computing taxable income, section 452 permits the taxpayer to elect a method of accounting for prepaid income under which portions of prepaid income received in the taxable year shall be deferred to subsequent taxable years. The general purpose of section 452 is to bring tax accounting more closely into harmony with generally accepted accounting principles; it is not intended to permit, for tax purposes, deferrals of income not properly deferred under the taxpayer's method of accounting.

(b) Section 446 provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 452 provides a specific method of accounting and, accordingly, the books of the taxpayer must be kept in accordance with such method if taxable income is to be computed under the method so elected. No election under section 452 may be made unless the prepaid income is deferred on the regular books of account which are used in computing the taxpayer's income and on the basis of which the taxpayer prepares his financial statements (such as reports to creditors, stockholders, etc.). If a taxpayer closes such books for the taxable year without making the necessary entries thereon to record such deferral, and issues his financial statements on the basis of the books as so closed, any such entries made thereafter will not be deemed to meet the requirements of the preceding sentence with respect to such taxable year; however, this rule is not applicable in the case of a taxpayer who has closed his books and issued financial statements for the taxable year before January 24, 1955, if he makes the necessary entries before making the election under section 452 (d) (3) (A) and paragraph (b) of § 1.452–7. In the case of a taxpayer (such as a regulated public utility defined in section 1503(c)) which is required by the rules of a governmental agency to maintain its books in accordance with a method of accounting different from that permitted by section 452, the method of accounting permitted by section 452 may be reflected in auxiliary records which shall be kept with, and reconciled with, the taxpayer's regular books. The deferral of prepaid income must be reflected on the books for a period not shorter than that prescribed for tax purposes. This is not to be construed as preventing the taxpayer from deferring prepaid income on his books, where proper, over a period longer than the period prescribed by section 452.

(c) For applicable definitions, see section 452 (e) and § 1.452–8.

§ 1.452–2 Prepaid income to be earned over short period.

(a) If prepaid income it attributable to a liability which will end before the first day of the sixth taxable year after the taxable year in which it is received, the income is deemed for purposes of section 452 to be "short-period prepaid income". Such income shall be included in gross income, to the extent properly allocable under the taxpayer's method of accounting, in the taxable year in which received and in each of the succeeding taxable years (not exceeding five) over which the liability may extend. The amount properly allocable to each of such taxable years shall be determined in the light of all the facts and circumstances involved, including the taxpayer's experience with such liabilities.

(b) Short-period prepaid income need not be allocated equally over the period, nor must any portion necessarily be included in the taxable year of receipt. A proper allocation under this section requires that such income be included in gross income as the liability to which the income relates is discharged or as it is deemed to be discharged on the basis of the taxpayer's experience. (Where experience is the basis for allocation, the taxpayer must follow the rules provided in paragraph (b) of § 1.452–3.) For example, if the rent for the fifth year under a five-year lease is paid at the beginning of the lease and the taxpayer-lessor has elected the benefits of section 452, and if the fifth year of the lease falls within two taxable years of the taxpayer, such rent shall be allocated to each of such two taxable years to the extent that the fifth year of the lease falls within each such taxable year. On the other hand, if the rent for the entire five years is received in advance, such rent shall be allocated to the taxable years covered by the lease.

[1] Sections 1.452 through 1.452–8, included in this republication, will not be carried in the Code of Federal Regulations.

The preceding sentence may be illustrated by the following example:

Example. Taxpayer A, using the accrual method, whose taxable year is a calendar year, leases a building to B for a period of 48 months commencing on February 1, 1955, for a total rent of $48,000 paid on December 1, 1954. Assuming that A has elected the benefits of section 452, rent from the lease shall be included in gross income as follows:

Taxable year:	*Amount included in gross income*
1954	0
1955	$11,000
1956	12,000
1957	12,000
1958	12,000
1959	1,000
Total	48,000

No part of the short-period prepaid rent is includible in gross income for the year 1954 since no part of the liability was discharged in that year.

(c) The determination of the period over which the liability extends is to be made on the basis of the facts known at the time the income is received. In order to treat prepaid income as short-period prepaid income, the taxpayer must be able to ascertain at the time of receipt of such income that the liability will end before the first day of the sixth taxable year after the taxable year in which the income is received.

(d) If subsequent events extend the period of liability, but it is not extended beyond the last day of the fifth taxable year following the taxable year of receipt of the prepaid income, the portion of the prepaid income not previously includible in gross income shall be allocated, in accordance with paragraphs (a) and (b) of this section, over the period remaining between the time the subsequent events become known and the expiration of the liability as changed.

(e) If subsequent events extend the period of liability beyond the close of the fifth taxable year following the taxable year of receipt of the prepaid income, the portion of the prepaid income not previously includible in gross income shall be allocated ratably over the period between the time the extended liability becomes known and the close of such fifth taxable year.

(f) If subsequent events shorten the period of liability, the portion of the prepaid income not previously includible in gross income shall be included in gross income for the taxable year in which the subsequent events occur if the liability does not extend beyond that taxable year. If the liability does extend beyond that taxable year, such portion shall be included in gross income over the period remaining between the time the subsequent events become known and the expiration of the liability as changed, in accordance with paragraphs (a) and (b) of this section.

(g) In the case of a change in the period of the liability described in paragraph (e) of this section, a taxpayer may request permission from the Commissioner to allocate the amount of prepaid income not previously includible in gross income in some manner other than that provided in such paragraph. The consent of the Commissioner shall be requested in accordance with § 1.452–5. Ordinarily, permission will not be granted to reallocate amounts properly includible in gross income for taxable years prior to the taxable year in which the change in the period of the liability occurs.

(h) For the purposes of the allocation under this section, the taxpayer may consider each transaction separately or may aggregate similar transactions during the taxable year in any reasonable manner provided the method of aggregation is consistently followed.

§ 1.452–3 Prepaid income to be earned over indefinite period.

(a) Prepaid income attributable to a liability, which on the basis of the facts known at the time such income is received extends over an indefinite period, shall be included in gross income in accordance with the provisions of this section. An example of prepaid income of this type is an amount received by a retail store for gift certificates which may be redeemed for merchandise at any time. There is to be included in gross income for the taxable year of receipt of an item of prepaid income described in this section and in gross income for each succeeding taxable year (not more than 5 years and not necessarily ratably) that portion of such prepaid income with respect to which the experience of the taxpayer indicates the liability will be discharged during each such taxable year. The remainder of the prepaid income must be accounted for one-sixth in the taxable year of receipt and one-sixth in each of the five succeeding taxable years.

(b) The allocation of income to be earned over an indefinite period shall be based upon the taxpayer's own experience, if adequate for a reasonable allocation. Ordinarily, the most recent six years of experience with this kind of prepaid income will be considered adequate for the purposes of this paragraph. However, if the taxpayer's experience is not adequate, he may use the experience of other taxpayers engaged in a similar trade or business if he establishes to the satisfaction of the Commissioner that such experience is representative of the taxpayer's business. In such case, if the taxpayer attaches to his return a complete statement of the experience relied upon, he may use such experience in computing taxable income on his return, subject to approval by the Commissioner upon subsequent examination of the return.

(c) The following example illustrates the provisions of this section:

Example:

Sale of service coupons		$1,000
Experience indicates that the coupons will be presented in payment for services as follows:		
50 percent in the year of sale	$500	
9 percent in the 1st succeeding year	90	
5 percent in the 2nd succeeding year	50	
3 percent in the 3rd succeeding year	30	
2 percent in the 4th succeeding year	20	
1 percent in the 5th succeeding year	10	
Total	700	
Amount to be accounted for during the first six years on the basis of experience		$700
Amount subject to pro rata allocation over the six year period		300
Allocated to each year, one-sixth of $300		50

Thus, the amount of income from the sale of service coupons to be included in gross income for the taxable year of sale is $500 plus $50, or $550, and for the first succeeding year is $90 plus $50, or $140, etc. However, if any portion of the amount received represents payment for coupons which the experience of the taxpayer indicates will never be presented for redemption, such portion may not be deferred beyond the taxable year in which the amount was received and shall be included in gross income for such taxable year. For example, if sales of coupons had been $1,100 instead of $1,000 and experience indicated that $100 of such amount would never be presented for redemption, the income from the sale of service coupons to be included in gross income for the taxable year of sale would be $500 plus $50 plus $100, or $650.

(d) For the purposes of the allocation under this section, the taxpayer may consider each transaction separately or may aggregate similar transactions during the taxable year in any reasonable manner provided the method of aggregation is consistently followed. It will be necessary for the taxpayer to evaluate annually his past experience in arriving at the proper allocation of prepaid income received during that taxable year.

(e) A taxpayer may not defer prepaid income relating to a liability of indefinite duration beyond the fifth taxable year after the taxable year of receipt unless he secures the consent of the Commissioner. A request for such consent shall be submitted in accordance with the provisions of § 1.452–5.

§ 1.452–4 Prepaid income to be earned over long period.

(a) Prepaid income attributable to a liability which, based upon the facts known at the time the income is received, will end after the close of the fifth taxable year following the taxable year in which such income is received shall be regarded as "long-period prepaid income". One-sixth of such income shall be included in gross income for the taxable year of receipt and one-sixth for each of the five succeeding taxable years unless the Commissioner consents to a different treatment. (See § 1.452–5.) For example, assume that the taxpayer, reporting taxable income on a calendar year basis, receives in the first year of a 10-year lease commencing on January 1, the first and the last year's rent. The annual rental is $6,000; the amount received in the first year is $12,000, of which only the $6,000 allocable to the 10th year's rent is prepaid income. The 10th year's rent shall be allocated $1,000 to each of the first six years of the lease, and taking into account the $6,000 rent for each such year, there will be a total of $7,000 included in income for each of the first six years. In each of the sev-

enth, eighth, and ninth years only the $6,000 rent for such year shall be taken into income. Since the tenth year's rent was included in income for the first six years, it is not to be included in income for the tenth year.

(b) One-sixth of the amount of long-period prepaid income shall be included in gross income for the taxable year of receipt. For example, if a taxpayer on the accrual method, on a calendar year basis receives a rental payment of $60,000 on December 1, 1954, covering full payment on a six-year lease commencing on January 1, 1955, $10,000 of such income is allocable to 1954, the taxable year of receipt, and a like amount to each of the five succeeding taxable years.

(c) Whether amounts received are short-period prepaid income or long-period prepaid income shall be determined by reference to the periods to which such amounts relate. For example, if, in connection with a ten-year lease beginning January 1, 1955, the rent for the fourth and sixth years is received in 1954, the amount of the rent for the fourth year is short-period prepaid income and the amount of the rent for the sixth year is long-period prepaid income. However, if in such example the lease were to begin on January 1, 1957, the rent for the fourth year would also be long-period prepaid income since the fourth year would fall more than five years after 1954, the year of receipt.

§ 1.452–5 Manner of obtaining consent for different treatment of prepaid income.

A taxpayer may, with the consent of the Commissioner, include prepaid income in gross income in such proportions, and for such taxable years, as are specified in the consent. The request for consent, in the case of prepaid income to which section 452 (a) (2) or 452 (b) applies, shall be made to the Commissioner not later than 30 days after the close of the taxable year in which such prepaid income is received. In the case of a request for consent described in section 452 (a) (1), the request shall be made to the Commissioner not later than 30 days after the close of the taxable year in which the change in the period of the liability became known. However, if the period prescribed above in this section for the filing of the request expires before September 7, 1955, the taxpayer may file the request for consent not later than September 7, 1955. The request shall contain both a detailed recital of the circumstances upon which the taxpayer bases his request for a method of allocation different from that provided in these regulations under section 452 and all the information necessary for the Commissioner to determine whether the proposed method of allocation would be proper and, if so, to what taxable years and in what amounts such allocations should be made. The request for consent should be directed to the Commissioner of Internal Revenue, Washington 25, D.C. Such permission will be granted by the Commissioner only in cases where it is shown to his satisfaction that a different method of treating prepaid income is proper.

§ 1.452–6 Treatment of prepaid income where taxpayer's liability ceases.

If the liability of the taxpayer ends, then so much of the prepaid income as was not includible in gross income for preceding taxable years shall be included in the gross income of the taxpayer for the taxable year in which the liability ends. See section 381(c)(7) for rules applicable to the treatment of prepaid income in the case of certain corporate acquisitions. If an individual taxpayer dies or a taxpayer other than an individual goes out of existence, the amount deferred under section 452 and not previously includible in his gross income shall, not withstanding the provisions of section 451(b), be included in his gross income for the taxable year in which such event occurs. Similarly, when a partnership terminates such amount shall be included in gross income for the year of termination of the partnership.

§ 1.452–7 Election of benefits.

(a) *In general.* An election under section 452 shall be applicable to all prepaid income (of the trade or business for which the election is made) which is received in the taxable year of the election and all subsequent taxable years. Such election shall not apply to any prepaid income received before the taxable year for which the election is made, even though the amounts will not be earned until after such year. The taxpayer may elect to include in his gross income for the taxable year of receipt all prepaid income with respect to which the liability is to end within 12 months of its receipt, if he files a statement to that effect at the time he makes his election under section 452. In such a case this treatment shall be consistently followed.

(2) An election under section 452 shall be binding for the taxable year for which made and all subsequent taxable years unless the consent of the Commissioner is obtained to change such method of treating prepaid income. See section 446 and the regulations thereunder.

(3) No election shall be permitted with respect to a trade or business if the cash receipts and disbursements method of accounting is used in computing taxable income or if such method is used, under a combination of methods, in reporting items of gross income for such trade or business for income tax purposes.

(4) If the taxpayer clearly evidences a bona fide intent to comply with the provisions of section 452 and the regulations thereunder, his election under that section will not be invalidated by:

(i) His failure to take certain items of prepaid income into account in accordance with the provisions of section 452 and these regulations;

(ii) His failure correctly to allocate prepaid income in accordance with such provisions; or

(iii) His improper deferral of items to which section 452 does not apply.

(b) *Manner of making election not requiring consent.* The election under section 452 may be made without the consent of the Commissioner if made for the first taxable year beginning after December 31, 1953 and ending after August 16, 1954 in which there is received prepaid income of the particular trade or business for which the election is made. The election must be made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The election shall be made in a statement attached to the taxpayer's return for the first taxable year to which the election is applicable. The statement shall contain the information required by paragraph (d) of this section.

(c) *Election requiring consent.* (1) If a taxpayer does not elect under paragraph (b) of this section he may elect the benefits of section 452 for his second taxable year beginning after December 31, 1953, and ending after August 16, 1954, provided that on or before June 30, 1955, he notifies the Commissioner of Internal Revenue, Washington 25, D.C., of his intention to make such election. The notification shall state that the taxpayer has not elected the benefits of section 452 for his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, but desires to elect the benefits of such section for the next succeeding taxable year. The notification shall be in triplicate, shall identify the trade or business to which the election is to apply, shall show the name and address of the taxpayer and the internal revenue district in which the return of the taxpayer is to be filed. In such a case the taxpayer's notification will be treated as an election to have the benefits of section 452 apply to such taxable year and to all subsequent taxable years. A copy of the notification will be stamped with the approval of the Commissioner and returned to the taxpayer. Such copy, together with a statement containing the information required by paragraph (d) of this section shall be attached to the return for the first taxable year to which the election applies.

(2) In the event that a taxpayer does not make an election under paragraph (b) of this section or subparagraph (1) of this paragraph, he may, at a later date, elect the benefits of the provisions of section 452 only if he obtains the consent of the Commissioner. In such a case, a written request for consent shall be made to the Commissioner not later than 90 days after the beginning of the first taxable year for which the election is applicable or September 7, 1955, whichever is later. Such request shall contain the information required by paragraph (d) of this section.

(d) *Information required.* The statement or request filed under paragraph (b) or (c) of this section shall set forth the following:

(1) The name and description of each trade or business for which the election is to apply;

(2) A declaration that the election is intended to apply to all prepaid income of the trade or business;

(3) The method of accounting used by the taxpayer in such trade or business;

(4) A description of each type of prepaid income of such trade or business,

the proposed method of allocation, and the basis therefor;

(5) Whether a previous election under the provisions of section 452 has been made for such trade or business and, if so, for what taxable years such election was in effect; and

(6) The name and description of each trade or business, if any, for which the election does not apply.

§ 1.452–8 Definitions.

(a) *Prepaid income.* The term "prepaid income" means any amount (includible in gross income) which is received in connection with, and is directly attributable to, a liability which extends beyond the close of the taxable year in which such amount is received. However, amounts which represent receipts for goods or services or for the use of property to have been provided or furnished during or prior to the taxable year of receipt are not prepaid income. The term may include, for example, amounts received in advance for rents and warehouse fees and amounts received from the sale of tickets, car tokens, subscriptions, club dues, and service coupons and contracts. Such term does not include any income treated as a gain from the sale or other disposition of a capital asset.

(b) *Liability.* The term "liability" means a liability to render services, furnish goods or other property, or allow the use of property. For example, an appliance service contract is a liability to render services for the purposes of section 452 if the contract is a separate transaction for which a charge is made and which is entered into at the option of the purchaser. The term does not include a liability under a warranty the consideration for which is, in effect, included in the selling price of a product.

(c) *Receipt of prepaid income.* For the purposes of section 452, prepaid income shall be treated as received during the taxable year for which it would be includible in gross income under section 451 and the regulations thereunder (determined without regard to section 452).

§ 1.453 Statutory provisions; installment method.

SEC. 453. *Installment Method*—(a) *Dealers in personal property.* Under regulations prescribed by the Secretary or his delegate, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of realty and casual sales of personalty*—(1) *General rule.* Income from—

(A) A sale or other disposition of real property, or

(B) A casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding $1,000,

may (under regulations prescribed by the Secretary or his delegate) be returned on the basis and in the manner prescribed in subsection (a).

(2) *Limitation.* Paragraph (1) shall apply—

(A) In the case of a sale or other disposition during a taxable year beginning after December 31, 1953 (whether or not such taxable year ends after the date of enactment of this title), only if in the taxable year of the sale or other disposition—

(i) There are no payments, or

(ii) The payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price.

(B) In the case of a sale or other disposition during a taxable year beginning before January 1, 1954, only if the income was (by reason of section 44 (b) of the Internal Revenue Code of 1939) returnable on the basis and in the manner prescribed in section 44 (a) of such code.

(c) *Change from accrual to installment basis*—(1) *General rule.* If a taxpayer entitled to the benefits of subsection (a) elects for any taxable year to report his taxable income on the installment basis, then in computing his taxable income for such year (referred to in this subsection as "year of change") or for any subsequent year—

(A) Installment payments actually received during any such year on account of sales or other dispositions of property made in any taxable year before the year of change shall not be excluded; but

(B) The tax imposed by this chapter for any taxable year (referred to in this subsection as "adjustment year") beginning after December 31, 1953, shall be reduced by the adjustment computed under paragraph (2).

(2) *Adjustment in tax for amounts previously taxed.* In determining the adjustment referred to in paragraph (1) (B), first determine, for each taxable year before the year of change, the amount which equals the lesser of—

(A) The portion of the tax for such prior taxable year which is attributable to the gross profit which was included in gross income for such prior taxable year, and which by reason of paragraph (1) (A) is includible in gross income for the taxable year, or

(B) The portion of the tax for the adjustment year which is attributable to the gross profit described in subparagraph (A).

The adjustment referred to in paragraph (1) (B) for the adjustment year is the sum of the amounts determined under the preceding sentence.

(3) *Rule for applying paragraph (2).* For purposes of paragraph (2), the portion of the tax for a prior taxable year, or for the adjustment year, which is attributable to the gross profit described in such paragraph is that amount which bears the same ratio to the tax imposed by this chapter (or by the corresponding provisions of prior revenue laws) for such taxable year (computed without regard to paragraph (2)) as the gross profit described in such paragraph bears to the gross income for such taxable year. For purposes of the preceding sentence, the provisions of chapter 1 (other than of subchapter D, relating to excess profits tax, and of subchapter E, relating to self-employment income) of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(d) *Gain or loss on disposition of installment obligations*—(1) *General rule.* If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and—

(A) The amount realized, in the case of satisfaction at other than face value or a sale or exchange, or

(B) The fair market value of the obligation at the time of distribution, transmission, or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange.

Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received.

(2) *Basis of obligation.* The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

(3) *Special rule for transmission at death.* Except as provided in section 691 (relating to recipients of income in respect of decedents), this subsection shall not apply to the transmission of installment obligations at death.

(4) *Effect of distribution in certain liquidations*—(A) *Liquidations to which section 332 applies.* If—

(i) An installment obligation is distributed by one corporation to another corporation in the course of a liquidation, and

(ii) Under section 332 (relating to complete liquidations of subsidiaries) no gain or loss with respect to the receipt of such obligation is recognized in the case of the recipient corporation,

then, no gain or loss with respect to the distribution of such obligation shall be recognized in the case of the distributing corporation.

(B) *Liquidations to which section 337 applies.* If—

(i) An installment obligation is distributed by a corporation in the course of a liquidation, and

(ii) Under section 337 (relating to gain or loss on sales or exchanges in connection with certain liquidations) no gain or loss would have been recognized to the corporation if the corporation had sold or exchanged such installment obligation on the day of such distribution,

then no gain or loss shall be recognized to such corporation by reason of such distribution.

§ 1.453–1 Installment method of reporting income.

(a) *In general.* Section 453 permits dealers in personal property, that is, persons who regularly sell or otherwise dispose of personal property on the installment plan, to return the income from the sale or other disposition thereof on the installment method. The installment method may also be applied with certain limitations (see paragraph (c) of this section) to the sale or other disposition of real property and the casual sale or other casual disposition of certain personal property.

(b) *Income to be reported.* Persons permitted to use the installment method of accounting prescribed in section 453 may return as income from installment sales in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when the property is paid for bears to the total contract price. In the case of dealers in personal property, for this purpose, gross profit means sales less cost of goods sold. See § 1.453–2 for rules applicable to the computation of income of dealers in personal property reporting on the installment method. In the case of sales of real estate and casual sales of personal property, gross profit means the selling price less the adjusted basis as defined in section 1011 and the regulations thereunder. Gross profit, in the case of a sale of real estate by a person other than a dealer and a casual sale of personal property, is reduced by commissions and other selling expenses for purposes of

determining the proportion of installment payments returnable as income. For rules applicable in determining "selling price" and the use of certain other terms, see also paragraph (c) of § 1.453–4.

(c) *Limitations on the use of the installment method.* (1) Income from the sale or other disposition of real property or from casual sales or other casual dispositions of personal property may be reported on the installment method for taxable years beginning after December 31, 1953, only if, in the taxable year of the sale or other disposition, (i) there are no payments or (ii) the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price.

(2) The income from a casual sale or other casual disposition of personal property may be reported on the installment method only if (i) the property is not of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, and (ii) its sale price exceeds $1,000.

(d) *Treatment of gain or loss on default by the purchaser of personal property sold on the installment plan.* If for any reason the purchaser defaults in any of his installment payments, and the vendor (whether he is a dealer in personal property or a person who has made a casual sale or other casual disposition of personalty), returning income on the installment method, repossesses the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the repossession occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the repossession or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value at the date of repossession of the property repossessed and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the repossession. (See also § 1.453–6.) The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the repossession of the property shall be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. For definition of the basis of an installment obligation, see section 453 (d) (2) and paragraph (b) (2) of § 1.453–9. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the repossession unless it is clearly shown that after the property was repossessed the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the repossession. (See also section 166 and the regulations thereunder.) If the property repossessed is bid in by the vendor at a lawful public auction or judicial sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary. The fair market value of the property repossessed shall be reflected in the appropriate permanent records of the vendor at the time of such repossession.

(e) *Other accounting methods.* If the vendor chooses as a matter of consistent practice to return the income from installment sales on an accrual method or on the cash receipts and disbursements method, such a course is permissible.

(f) *Records.* In adopting the installment method of accounting the seller must maintain such records as are necessary to clearly reflect income in accordance with this section, section 446 and § 1.446–1.

§ 1.453–2 Special rules applicable to dealers in personal property.

(a) *In general.* A person who regularly sells personal property on the installment plan may adopt (but is not required to do so), one of the following four ways of protecting his interest in case of default by the purchaser:

(1) By an agreement that title is to remain in the vendor until the purchaser has completely performed his part of the transaction;

(2) By a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the selling price;

(3) By a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the vendor; or

(4) By conveyance to a trustee pending performance of the contract and subject to its provisions.

(b) *Installment income of dealers in personal property.* The income from installment sales of a dealer, that is, a person regularly engaged in the sale of personal property on the installment plan, may be ascertained by treating as income that proportion of the total payments received in the taxable year from installment sales (such payments being allocated to the year against the sales of which they apply) which the gross profit realized or to be realized on the total installment sales made during each year bears to the total contract price of all such sales made during that respective year. A dealer who desires to compute income by the installment method shall maintain accounting records in such a manner as to enable an accurate computation to be made by such method in accordance with the provisions of this section, section 446, and § 1.446–1.

(c) *Treatment of payments on sales made in years prior to change to installment method.* No payments received in the taxable year shall be excluded in computing the amount of income to be returned on the ground that they were received under a sale the total profit from which was returned as income during a taxable year or years prior to the change by the taxpayer to the installment method of returning income. In this regard, however, see section 453 (c) and § 1.453–7 for the computation of the adjustments for amounts previously included in income in the case of a change from an accrual method to the installment method. Deductible items are not to be allocated to the years in which the profits from the sales of a particular year are to be returned as income, but must be deducted for the taxable year in which the items are "paid or incurred" or "paid or accrued". See section 461 and the regulations thereunder in this part, and section 7701(a)(25) and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration).

§ 1.453–3 Special rules applicable to casual sales or casual dispositions of personal property.

Income shall be computed and reported separately for each casual sale or other casual disposition of personal property as installment payments are received in the year of sale and subsequent years. See paragraph (c) of § 1.453–1 for limitations on the use of the installment method.

§ 1.453–4 Sale of real property involving deferred periodic payments.

(a) *In general.* Sales of real property involving deferred payments include (1) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (2) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

(b) *Classes of sales.* Such sales, under either paragraph (a) (1) or (2) of this section, fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of real property which may be accounted for on the installment method, that is, sales of real property in which (i) there are no payments during the taxable year of the sale or (ii) the payments in such taxable year (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price, or

(2) Deferred-payment sales of real property in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

(c) *Determination of "selling price".* In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall, for the purpose of determining whether a sale is on the installment plan, be included as a part of the "selling price"; and for the purpose of determining the payments and the total contract price as those terms are used in section 453, and §§ 1.453–1 through 1.453–7, the amount of such mortgage shall be included only

to the extent that it exceeds the basis of the property. The term "payments" does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Commissions and other selling expenses paid or incurred by the vendor shall not reduce the amount of the payments, the total contract price, or the selling price.

§ 1.453–5 Sale of real property treated on installment method.

(a) *In general.* In any transaction described in paragraph (b) (1) of § 1.453–4, that is, sales of real property in which there are no payments during the year of sale or the payments in that year do not exceed 30 percent of the selling price, the vendor may return as income from each such transaction in any taxable year that proportion of the installment payments actually received in that year which the gross profit (as described in paragraph (b) of § 1.453–1) realized or to be realized when the property is paid for bears to the total contract price. In any case, the sale of each lot or parcel of a subdivided tract must be treated as a separate transaction and gain or loss computed accordingly. (See paragraph (a) of § 1.61–6.)

(b) *Defaults and repossessions.* If the purchaser of real property on the installment plan defaults in any of his payments, and the vendor returning income on the installment method reacquires the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the reacquisition occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the reacquisition or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value at the date of reacquisition of the property reacquired (including the fair market value of any fixed improvements placed on the property by the purchaser) and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the reacquisition. The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the reacquisition of the property will be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. For definition of the basis of an installment obligation, see section 453 (d) (2) and paragraph (b) (2) of § 1.453–9. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the reacquisition of the property, unless it is clearly shown that after the property was reacquired the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the reacquisition. (See section 166 and the regulations thereunder.) If the property reacquired is bid in by the vendor at a foreclosure sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition (including the fair market value of any fixed improvements placed on the property by the purchaser).

§ 1.453–6 Deferred-payment sale of real property not on installment method.

(a) *Value of obligations.* (1) In transactions included in paragraph (b) (2) of § 1.453–4, that is, sales of real property involving deferred payments in which the payments received during the year of sale exceed 30 percent of the selling price, the obligations of the purchaser received by the vendor are to be considered as an amount realized to the extent of their fair market value in ascertaining the profit or loss from the transaction. Such obligations, however, are not considered in determining whether the payments during the year of sale exceed 30 percent of the selling price.

(2) If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount thereof being the difference between the reduced basis as provided in the preceding sentence and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

(b) *Title retained by vendor.* (1) If the vendor in sales referred to in paragraph (a) of this section has retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property, the difference between (i) the entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser and (ii) the sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser had the sale not been made, will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed.

(2) The basis of the property described in subparagraph (1) of this paragraph in the hands of the vendor will be the original basis at the time of the sale plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser, except as provided in subparagraph (3) of this paragraph.

(3) With respect to repossessions occurring after September 18, 1958, the basis of property determined in accordance with subparagraph (2) of this paragraph shall be reduced by what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser had the sale not been made.

(c) *Title transferred to purchaser.* If the vendor in sales described in paragraph (a) of this section has previously transferred title to the purchaser, and the purchaser defaults in any of his payments, and the vendor accepts a voluntary reconveyance of the property, in partial or full satisfaction of the unpaid portion of the purchase price, the receipt of the property so reacquired, to the extent of its fair market value at that time, including the fair market value of fixed improvements placed on the property by the purchaser, shall be considered as the receipt of payment on the obligations satisfied. If the fair market value of the property is greater than the basis of the obligations of the purchaser so satisfied (generally, such basis being the fair market value of such obligations previously recognized in computing income), the excess constitutes ordinary income. If the value of such property is less than the basis of such obligations, the difference may be deducted as a bad debt if uncollectible, except that if the obligations satisfied are securities (as defined in section 165 (g) (2) (C)), any gain or loss resulting from the transaction is a capital gain or loss subject to the provisions of sections 1201 through 1241. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition including the fair market value of the fixed improvements placed on the property by the purchaser. See section 166 and the regulations thereunder with respect to property reacquired in a foreclosure proceeding.

§ 1.453–7 Change from accrual to installment method by dealers.

(a) *In general.* A taxpayer who is a dealer in personal property and who is entitled to the benefits of section 453(a) may elect to report his taxable income on the installment method of accounting without securing consent of the Commissioner. In the event a dealer elects to change from an accrual method of accounting to the installment method, any installment payments actually received in the year of change or in subsequent taxable years on account of sales or other dispositions of property made in any taxable year before the year of change shall not be excluded from taxable income. This means that profits attributable to installment sales even though included in taxable income in their entirety in a year of sale before the year in which the change to the installment method is made are also includible in taxable income as payments are re-

ceived in the year of change and in subsequent taxable years. But the tax imposed for the year of change or any subsequent taxable years (such years being referred to as "adjustment years") beginning after December 31, 1953, shall be reduced by an adjustment proportionate to the tax attributable to the gross profit which is, by reason of the change to the installment method, included in gross income a second time, determined by the method of computation described in section 453 (c) and paragraph (b) of this section.

(b) *Adjustment to tax.* (1) The adjustment to tax under section 453 (c) (2) is determined as follows:

(i) Determine separately the portion of the tax for each taxable year before the year of change which is attributable to the gross profit from installment sales which was included in gross income in that year and which is also includible in gross income for any adjustment year;

(ii) Determine separately the portion of the tax for each adjustment year which is attributable to the gross profit described in subdivision (i) of this subparagraph;

(iii) Select for each adjustment year the lesser of the amounts determined under subdivisions (i) and (ii) of this subparagraph;

(iv) The tax imposed in any adjustment year shall be reduced by the amount as determined in subdivision (iii) of this subparagraph or the sum of all such amounts if more than one prior taxable year is involved;

(v) The portion of the tax for any taxable year attributable to the gross profit described in subdivision (i) of this subparagraph shall be that proportion of the tax determined for such year without regard to the adjustments under this paragraph, which the gross profit included in gross income in the prior year and includible in gross income for the adjustment year bears to the gross income of that year.

(2) The tax determined in any of the steps provided in subparagraph (1) of this paragraph shall be the tax imposed by chapter 1, subtitle A of the Internal Revenue Code of 1954; or chapter 1, not including subchapter D, relating to excess profits tax, nor subchapter E, relating to tax on self-employment income, of the Internal Revenue Code of 1939.

(3) The computation of the adjustment provided in section 453 (c) (2) may be illustrated by the following example:

ADJUSTMENTS IN TAX ON CHANGE TO INSTALLMENT METHOD

	Taxable years (prior to change)		Adjustment years (after change)	
	Year 1	Year 2	Year 3	Year 4
Gross profit from installment sales (receivable in periodic payments over 5 years)	$100,000		$20,000 (1)	$12,000 (4)
		$50,000	10,000 (2)	8,000 (5)
			80,000 (3)	40,000 (6)
				90,000 (7)
Other income	80,000	200,000	90,000	90,000
Gross income	180,000	250,000	200,000	240,000
Deductions	60,000	50,000	50,000	60,000
Taxable income	120,000	200,000	150,000	180,000
Tax rate assumed (percent)	30	50	40	40
Tax would be	$36,000	$100,000	$60,000	$72,000

		Lesser tax portion
	COMPUTATION OF ADJUSTMENT IN YEAR 3	
	Year 1 items	
In year 3 (portion of tax)	20,000/200,000×60,000=$6,000	
In year 1 (portion of tax)	20,000/180,000×36,000=$4,000	$4,000
	Year 2 items	
In year 3 (portion of tax)	10,000/200,000×60,000=$3,000	3,000
In year 2 (portion of tax)	10,000/250,000×100,000=$4,000	
Adjustment to tax of year 3		7,000

See footnotes at end of table.

ADJUSTMENTS IN TAX ON CHANGE TO INSTALLMENT METHOD—Continued

		Lesser tax portion
	COMPUTATION OF ADJUSTMENT IN YEAR 4	
	Year 1 items	
In year 4 (portion of tax)	12,000/240,000×72,000=$3,600	
In year 1 (portion of tax)	12,000/180,000×36,000=$2,400	$2,400
	Year 2 items	
In year 4 (portion of tax)	8,000/240,000×72,000=$2,400	2,400
In year 2 (portion of tax)	8,000/250,000×100,000=$3,200	
Adjustment to tax of year 4		4,800

(1) and (4) from year 1 sales.
(2) and (5) from year 2 sales.
(3) and (6) from year 3 sales.
(7) from year 4 sales.

(c) *Special rules for partnerships.* In the case of a change from an accrual method of accounting to the installment method of accounting by a partnership which is a dealer in personal property, payments attributable to installment sales under such accrual method shall be included in the gross income of the partnership in their entirety as payments are received in the year of change and in subsequent taxable years, even though included in gross income of the partnership for a year before the year in which the change to the installment method is made. Each partner's distributive share of the profits attributable to installment sales included in partnership taxable income for the year of sale and for each "adjustment year" shall be taken into account separately in accordance with section 702(a)(8) and paragraph (a)(8) of § 1.702–1. The income tax of each partner for adjustment years shall be computed with the adjustment provided by section 453(c)(2) for amounts previously taxed. However, it is not necessary for a partner to have been a member of the partnership for the year of sale and each subsequent taxable year, including adjustment years, in order to apply the adjustment to tax provided by section 453(c)(2).

§ 1.453–8 Requirements for adoption of or change to installment method.

(a) *Dealers in personal property*—(1) *Adoption of installment method.* A taxpayer who adopts the installment method of accounting in the first taxable year in which he makes installment sales must indicate in his income tax return for that taxable year that the installment method of accounting is being adopted.

(2) *Change to installment method.* A taxpayer who changes to the installment method in accordance with § 1.453–7 shall attach a statement to his income tax return for the taxable year with respect to which the change is made. This statement must show—

(i) The method of accounting used in computing taxable income before the change;

(ii) The span of taxable years over which it will be necessary to compute adjustments; and

(iii) A schedule similar to the schedule shown in the example in paragraph (b) (3) of § 1.453–7, showing the computation of the required adjustments under section 453 (c) (2).

Similar statements must be attached to and filed with income tax returns for subsequent taxable years in which adjustments are required because of the inclusion of installment payments in gross income a second time.

(b) *Sales of real property and casual sales of personal property.* (1) A taxpayer who sells or otherwise disposes of real property, or who makes a casual sale or other casual disposition of personal property, and who elects to report the income therefrom on the installment method must set forth in his income tax return (or in a statement attached thereto) for the year of the sale or other disposition the computation of the gross profit on the sale or other disposition under the installment method. In any taxable year in which the taxpayer receives payments attributable to such sale or other disposition, he must also show

in his income tax return the computation of the amount of income which is being reported in that year on such sale or other disposition.

(2) The information required by subparagraph (1) of this paragraph must be submitted for each separate sale or other disposition but, in the case of multiple sales or other dispositions, separate computations may be shown in a single statement.

(c) *Installment method and other accounting methods.* Notwithstanding the fact that a dealer in personal property may change to the installment method of accounting without permission, a dealer may not change from the installment method of accounting for sales on the installment plan to an accrual method of accounting or to any other method of accounting without the permission of the Commissioner.

§ 1.453–9 Gain or loss on disposition of installment obligations.

(a) *In general.* Subject to the exceptions contained in section 453(d)(4) and paragraph (c) of this section, the entire amount of gain or loss resulting from any disposition or satisfaction of installment obligations, computed in accordance with section 453 (d), is recognized in the taxable year of such disposition or satisfaction and shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received by the taxpayer.

(b) *Computation of gain or loss.* (1) The amount of gain or loss resulting under paragraph (a) of this section is the difference between the basis of the obligation and (i) the amount realized, in the case of satisfaction at other than face value or in the case of a sale or exchange, or (ii) the fair market value of the obligation at the time of disposition, if such disposition is other than by sale or exchange.

(2) The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

(3) The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example (1). In 1960 the M Corporation sold a piece of unimproved real estate to B for $20,000. The company acquired the property in 1948 at a cost of $10,000. During 1960 the company received $5,000 cash and vendee's notes for the remainder of the selling price, or $15,000, payable in subsequent years. In 1962, before the vendee made any further payments, the company sold the notes for $13,000 in cash. The corporation makes its returns on the calendar year basis. The income to be reported for 1962 is $5,500, computed as follows:

Proceeds of sale of notes		$13,000
Selling price of property	$20,000	
Cost of property	10,000	
Total profit	10,000	
Total contract price	20,000	
Percent of profit, or proportion of each payment returnable as income, $10,000 divided by $20,000, 50 percent.		
Face value of notes	15,000	
Amount of income returnable were the notes satisfied in full, 50 percent of $15,000	7,500	
Basis of obligation—excess of face value of notes over amount of income returnable were the notes satisfied in full		7,500
Taxable income to be reported for 1962		5,500

Example (2). Suppose in example (1) the M Corporation, instead of selling the notes, distributed them in 1962 to its shareholders as a dividend, and at the time of such distribution, the fair market value of the notes was $14,000. The income to be reported for 1962 is $6,500, computed as follows:

Fair market value of notes		$14,000
Basis of obligation—excess of face value of notes over amount of income returnable were the notes satisfied in full (computed as in example (1))	7,500	
Taxable income to be reported for 1962		6,500

(c) *Disposition from which no gain or loss is recognized.* (1) Under section 453 (d) (4), no gain or loss shall be recognized to a distributing corporation with respect to the distribution of installment obligations in certain corporate liquidations, under the following conditions:

(i) If the distribution is made, pursuant to a plan for the complete liquidation of a subsidiary meeting the requirements of section 332, to a corporation in the hands of which no gain or loss is recognized with respect to such distribution, or

(ii) If the distribution is made, pursuant to a plan for the complete liquidation of a corporation which meets the requirements of section 337, under conditions whereby no gain or loss would have been recognized to the corporation had such installment obligations been sold or exchanged on the day of distribution.

(2) Where the Code provides for exceptions to the recognition of gain or loss in the case of certain dispositions, no gain or loss shall result under section 453(d) in the case of a disposition of an installment obligation. Such exceptions include: Certain transfers to corporations under sections 351 and 361; contributions of property to a partnership by a partner under section 721; and distributions by a partnership to a partner under section 731 (except as provided by section 736 and section 751).

(3) Any amount received by a person in payment or settlement of an installment obligation acquired in a transaction described in subparagraphs (1) or (2) of this paragraph (other than an amount received by a stockholder with respect to an installment obligation distributed to him pursuant to section 337) shall be considered to have the character it would have had in the hands of the person from whom such installment obligation was acquired.

(d) *Carryover of installment method.* For the treatment of income derived from installment obligations received in transactions to which section 381 (a) is applicable, see section 381 (c) (8) and the regulations thereunder.

(e) *Installment obligations transmitted at death.* Where installment obligations are transmitted at death, see section 691 (a) (4) and the regulations thereunder for the treatment of amounts considered income in respect of a decedent.

(f) *Losses.* See subchapter P (section 1201 and following), chapter 1 of the Code, as to the limitation on capital losses sustained by corporations and the limitation as to both capital gains and capital losses of individuals.

§ 1.453–10 Effective date.

(a) Except as provided in this section, the provisions of section 453 and §§ 1.453–1 through 1.453–7, and § 1.453–9 shall apply to any taxable year beginning after December 31, 1953, and ending after August 16, 1954.

(b) The provisions of § 1.453–8 shall apply to taxable years ending after December 17, 1958.

(c) Under the provisions of sections 453 (b) and 7851 (a) (1) (C), section 453 (b) (1) and the regulations with respect thereto shall also apply—

(1) To a sale or other disposition during a taxable year beginning before January 1, 1954, only if the income was returnable (by reason of section 44 (b) of the Internal Revenue Code of 1939) on the basis and in the manner prescribed in section 44 (a) of such code.

(2) To a sale or other disposition during a taxable year beginning after December 31, 1953, and ending before August 17, 1954, though such taxable year is subject to the provisions of the Internal Revenue Code of 1939.

(d) Under the provisions of sections 453 (c) (1) (B) and 7851 (a) (1) (C), section 453 (c) and the regulations with respect thereto shall also apply to taxable years beginning after December 31, 1953, and ending before August 17, 1954, though such taxable years are subject to the provisions of the Internal Revenue Code of 1939.

(e) The provisions of paragraph (b) (3) of § 1.453–6 shall apply to repossessions occurring after December 18, 1958.

§ 1.454 Statutory provisions; obligations issued at discount.

SEC. 454. *Obligations issued at discount*—(a) *Non-interest-bearing obligations issued at a discount.* If, in the case of a taxpayer owning any non-interest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals or owning an obligation described in paragraph (2) of subsection (c), the increase in the redemption price of such obligation occurring in the taxable year does not (under the method of accounting used in computing his taxable income) constitute income to him in such year, such taxpayer may, at his election made in his return for any taxable year, treat such increase as income received in such taxable year. If any such election is made with respect to any such obligation, it shall apply also to all such obligations owned by the taxpayer at the beginning of the first taxable year to which it applies and to all such obligations thereafter acquired by him and shall be binding for all subsequent taxable years, unless on application by the taxpayer the Secretary or his delegate permits him, subject to such

conditions as the Secretary or his delegate deems necessary, to change to a different method. In the case of any such obligations owned by the taxpayer at the beginning of the first taxable year to which his election applies, the increase in the redemption price of such obligations occurring between the date of acquisition (or, in the case of an obligation described in paragraph (2) of subsection (c), the date of acquisition of the series E bond involved) and the first day of such taxable year shall also be treated as income received in such taxable year.

(b) *Short-term obligations issued on discount basis.* In the case of any obligation—

(1) Of the United States; or

(2) Of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia,

which is issued on a discount basis and payable without interest at a fixed maturity date not exceeding 1 year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of.

(c) *Matured United States savings bonds.* In the case of a taxpayer who—

(1) Holds a series E United States savings bond at the date of maturity, and

(2) Pursuant to regulations prescribed under the Second Liberty Bond Act retains his investment in the maturity value of such series E bond in an obligation, other than a current income obligation, which matures not more than 10 years from the date of maturity of such series E bond,

the increase in redemption value (to the extent not previously includible in gross income) in excess of the amount paid for such series E bond shall be includible in gross income in the taxable year in which the obligation is finally redeemed or in the taxable year of final maturity, whichever is earlier. This subsection shall not apply to a corporation, and shall not apply in the case of any taxable year for which the taxpayer's taxable income is computed under an accrual method of accounting or for which an election made by the taxpayer under subsection (a) applies.

§ 1.454–1 Obligations issued at discount.

(a) *Non-interest-bearing obligations issued at discount.* (1) If a taxpayer—

(i) Owns any non-interest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals, or

(ii) Retains his investment in the maturity value of a series E United States savings bond, in the manner described in section 454 (c) (2), and

if the increase in redemption price of such obligation, described in subdivision (i) or (ii) of this subparagraph, occurring in the taxable year does not constitute income for such year under the method of accounting used in computing his taxable income, then the taxpayer may, at his election, treat the increase as constituting income for the year in which such increase occurs, rather than for the year in which the obligation is disposed of, redeemed, paid at maturity, or converted into a current income obligation of the United States (such as a bond of series G or K). Any such election must be made in the taxpayer's return and may be made for any taxable year. If an election is made with respect to any such obligation, it shall apply also to all other obligations of the type described in this paragraph owned by the taxpayer at the beginning of the first taxable year to which the election applies and to those thereafter acquired by him, and shall be binding for the taxable year for which the return is filed and for all subsequent taxable years, unless the Commissioner permits the taxpayer to change to a different method of reporting income from such obligations. See section 446 (e) and paragraph (e) of § 1.446–1, relating to requirement respecting a change of accounting method. Although the election once made is binding upon the taxpayer, it does not apply to a transferee of the taxpayer.

(2) In any case in which an election is made under section 454, the amount which accrues in any taxable year to which the election applies is measured by the actual increase in the redemption price occurring in that year. This amount does not accrue ratably between the dates on which the redemption price changes. For example, if two dates on which the redemption price increases (February 1 and August 1) fall within a taxable year and if the redemption price increases in the amount of 50 cents on each such date, the amount accruing in that year would be $1.00 ($0.50 on February 1 and $0.50 on August 1). If the taxpayer owns a non-interest-bearing obligation of the character described in subparagraph (1) of this paragraph acquired prior to the first taxable year to which his election applies, he must also include in gross income for such first taxable year the increase in the redemption price of such obligation occurring between the date of acquisition of the obligation (or the series E bond involved in the case of a matured United States savings bond), and the first day of such first taxable year.

(3) The provisions of this paragraph are illustrated by the following example:

Example. Throughout the calendar year 1954, a taxpayer who computes his taxable income under the cash receipts and disbursements method holds series E United States savings bonds having a maturity value of $5,000 and a redemption value at the beginning of the year 1954 of $4,050 and at the end of the year 1954 of $4,150. He purchased the bonds on January 1, 1949, for $3,750, and holds no other obligation of the type described in this section. If the taxpayer exercises the election in his return for the calendar year 1954, he is required to include $400 in taxable income with respect to such bonds. Of this amount, $300 represents the increase in the redemption price before 1954 and $100 represents the increase in the redemption price in 1954. The increases in redemption value occurring in subsequent taxable years are includible in gross income for such taxable years.

(b) *Short-term obligations issued on a discount basis.* In the case of obligations of the United States or any of its possessions, or of a State, or Territory, or any political subdivision thereof, or of the District of Columbia, issued on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation originally sold does not accrue until the date on which such obligation is redeemed, sold, or otherwise disposed of. This rule applies regardless of the method of accounting used by the taxpayer. For examples illustrating rules for computation of income from sale or other disposition of certain obligations of the type described in this paragraph, see section 1221 and the regulations thereunder.

(c) *Matured United States savings bonds.* If a taxpayer (other than a corporation) holds a series E United States savings bond at the date of maturity, and under the regulations prescribed under the Second Liberty Bond Act retains his investment in the maturity value of such series E bond in an obligation, other than a current income obligation, which matures not more than 10 years from the date of maturity of such series E bond, the increase in redemption value not previously includible in gross income in excess of the amount paid for such series E bond shall be includible in gross income in the taxable year in which the obligation is finally redeemed or in the taxable year of final maturity, whichever is earlier. The provisions of section 454 (c) and of this paragraph shall not apply in the case of any taxable year for which the taxpayer's taxable income is computed under an accrual method of accounting or for a taxable year for which an election made by the taxpayer under section 454 (a) and paragraph (a) of this section applies.

TAXABLE YEAR FOR WHICH DEDUCTIONS TAKEN

§ 1.461 Statutory provisions; general rule for taxable year of deduction.

SEC. 461. *General rule for taxable year of deduction*—(a) *General rule.* The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

(b) *Special rule in case of death.* In the case of the death of a taxpayer whose taxable income is computed under an accrual method of accounting, any amount accrued as a deduction or credit only by reason of the death of the taxpayer shall not be allowed in computing taxable income for the period in which falls the date of the taxpayer's death.

(c) *Accrual of real property taxes*—(1) *In general.* If the taxable income is computed under an accrual method of accounting, then, at the election of the taxpayer, any real property tax which is related to a definite period of time shall be accrued ratably over that period.

(2) *Special rules.* Paragraph (1) shall not apply to any real property tax, to the extent that such tax was allowable as a deduction under the Internal Revenue Code of 1939 for a taxable year which began before January 1, 1954. In the case of any real property tax which would, but for this subsection, be allowable as a deduction for the first taxable year of the taxpayer which begins after December 31, 1953, then, to the extent that such tax is related to any period before the first day of such first taxable year, the tax shall be allowable as a deduction for such first taxable year.

(3) *When election may be made*—(A) *Without consent.* A taxpayer may, without the consent of the Secretary or his delegate, make an election under this subsection for his first taxable year which begins after December 31, 1953, and ends after the date of enactment of this title in which the taxpayer incurs real property taxes. Such an election shall be made not later than the time prescribed by law for filing the return for such year (including extensions thereof).

(B) *With consent.* A taxpayer may, with the consent of the Secretary or his delegate, make an election under this subsection at any time.

§ 1.461–1 General rule for taxable year of deduction.

(a) *General rule*—(1) *Taxpayer using cash receipts and disbursements method.* Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) *Taxpayer using an accrual method.* Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

(3) *Other factors which determine when deductions may be taken.* (i) Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year cannot be used to reduce the income of a subsequent year. A taxpayer may not take advantage in a return for a subsequent year of his failure to claim deductions in a prior taxable year in which such deductions should have been properly taken under his method of accounting. If a taxpayer ascertains that a deduction should have been claimed in a prior taxable year, he should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arisng therefrom. Similarly, if a taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account.

(ii) Where there is a dispute and the entire liability is contested, judgments on account of damages for patent infringement, personal injuries or other causes, or other binding adjudications, including decisons of referees and boards of review under workmen's compensation laws, are deductions from gross income when the claim is finally adjudicated or is paid, depending upon the taxpayer's method of accounting. However, see subparagraph (2) of this paragraph.

(iii) For special rules relating to certain deductions, see the following sections and the regulations thereunder: Section 1481, relating to accounting for amounts repaid in connection with renegotiaton of a government contract; section 1341, relating to the computation of tax where the taxpayer repays a substantial amount received under a claim of right in a prior taxable year; and section 165 (e), relating to losses resulting from theft.

(4) *Deductions attributable to certain foreign income.* In any case in which, owing to monetary, exchange, or other restrictions imposed by a foreign country, an amount otherwise constituting gross income for the taxable year from sources without the United States is not includible in gross income of the taxpayer for that year, the deductions and credits properly chargeable against the amount so restricted shall not be deductible in such year but shall be deductible proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income. See paragraph (b) of § 1.905–1 for rules relating to credit for foreign income taxes when foreign income is subject to exchange controls.

(b) *Special rule in case of death.* A taxpayer's taxable year ends on the date of his death. See section 443 (a) (2) and paragraph (a) (2) of § 1.443–1. In computing taxable income for such year, there shall be deducted only amounts properly deductible under the method of accounting used by the taxpayer. However, if the taxpayer used an accrual method of accounting, no deduction shall be allowed for amounts accrued only by reason of his death. For rules relating to the inclusion of items of partnership deduction, loss, or credit in the return of a decedent partner, see subchapter K, chapter 1 of the Code, and the regulations thereunder.

(c) *Accrual of real property taxes*—(1) *In general.* If the accrual of real property taxes is proper in connection with one of the methods of accounting described in section 446 (c), any taxpayer using such a method of accounting may elect to accrue any real property tax, which is related to a definite period of time, ratably over that period in the manner described in this paragraph. For example, assume that such an election is made by a calendar-year taxpayer whose real property taxes, applicable to the period from July 1, 1955, to June 30, 1956, amount to $1,200. Under section 461 (c), $600 of such taxes accrue in the calendar year 1955, and the balance accrues in 1956. For general rules relating to deductions for taxes, see section 164 and the regulations thereunder.

(2) *Special rules*—(i) *Effective date.* Section 461 (c) and this paragraph do not apply to any real property tax allowable as a deduction under the Internal Revenue Code of 1939 for any taxable year beginning before January 1, 1954.

(ii) If real property taxes which relate to a period prior to the taxpayer's first taxable year beginning on or after January 1, 1954, would, but for section 461 (c), be deductible in such first taxable year, the portion of such taxes which applies to the prior period is deductible in such first taxable year (in addition to the amount allowable under section 461 (c) (1)).

(3) *When election may be made*—(i) *Without consent.* A taxpayer may elect to accrue real property taxes ratably in accordance with section 461 (c) and this paragraph without the consent of the Commissioner for his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in which the taxpayer incurs real property taxes. Such election must be made not later than the time prescribed by law for filing the return for such year (including extensions thereof). An election may be made by the taxpayer for each separate trade or business (and for nonbusiness activities, if accounted for separately). Such an election shall apply to all real property taxes of the trade, business, or nonbusiness activity for which the election is made. The election shall be made in a statement submitted with the taxpayer's return for the first taxable year to which the election is applicable. The statement should set forth:

(*a*) The trades or businesses, or nonbusiness activity, to which the election is to apply, and the method of accounting used therein;

(*b*) The period of time to which the taxes are related; and

(*c*) The computation of the deduction for real property taxes for the first year of the election (or a summary of such computation).

(ii) *With consent.* A taxpayer may elect with the consent of the Commissioner to accrue real property taxes ratably in accordance with section 461 (c) and this paragraph. A written re-

quest for permission to make such an election shall be submitted to the Commissioner of Internal Revenue, Washington 25, D. C., within 90 days after the beginning of the taxable year to which the election is first applicable, or before March 26, 1958, whichever date is later. The request for permission shall state:

(a) The name and address of the taxpayer;

(b) The trades or businesses, or nonbusiness activity, to which the election is to apply, and the method of accounting used therein;

(c) The taxable year to which the election first applies;

(d) The period to which the real property taxes relate;

(e) The computation of the deduction for real property taxes for the first year of election (or a summary of such computation); and

(f) An adequate description of the manner in which all real property taxes were deducted in the year prior to the year of election.

(4) *Binding effect of election.* An election to accrue real property taxes ratably under section 461 (c) is binding upon the taxpayer unless the consent of the Commissioner is obtained under section 446 (e) and paragraph (e) of § 1.446–1 to change such method of deducting real property taxes. If the last day prescribed by law for filing a return for any taxable year (including extensions thereof) to which section 461 (c) is applicable falls before March 25, 1958, consent is hereby given for the taxpayer to revoke an election previously made to accrue real property taxes in the manner prescribed by section 461 (c). If the taxpayer revokes his election under the preceding sentence, he must, on or before March 25, 1958, notify the district director for the district in which the return was filed of such revocation. For any taxable year for which such revocation is applicable, an amended return reflecting such revocation shall be filed on or before March 25, 1958.

(5) *Apportionment of taxes on real property between seller and purchaser.* For apportionment of taxes on real property between seller and purchaser, see section 164 (d) and the regulations thereunder.

(6) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). A taxpayer on an accrual method reports his taxable income for the taxable year ending June 30. He elects to accrue real property taxes ratably for the taxable year ending June 30, 1955 (which is his first taxable year beginning on or after January 1, 1954). In the absence of an election under section 461 (c), such taxes would accrue on January 1 of the calendar year to which they are related. The real property taxes are $1,200 for 1954; $1,600 for 1955; and $1,800 for 1956. Deductions for such taxes for the fiscal years ending June 30, 1955, and June 30, 1956, are computed as follows:

Fiscal year ending June 30, 1955

July through December 1954	[1]None
January through June 1955 (6/12 of $1,600)	$800
Deduction for fiscal year ending June 30, 1955	800

Fiscal year ending June 30, 1956

July through December 1955 (6/12 of $1,600)	$800
January through June 1956 (6/12 of $1,800)	900
Deduction for fiscal year ending June 30, 1956	1,700

[1] The taxes for 1954 were deductible in the fiscal year ending June 30, 1954, since such taxes accrued on January 1, 1954.

Example (2). A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461 (c), such taxes would accrue on July 1 and are assessed for the 12-month period beginning on that date. The real property taxes assessed for the year ending June 30, 1954, are $1,200; $1,600 for the year ending June 30, 1955; and $1,800 for the year ending June 30, 1956. Deductions for such taxes for the calendar years 1954 and 1955 are computed as follows:

Year ending December 31, 1954

January through June 1954	[1]None
July through December 1954 (6/12 of $1,600)	$800
Deduction for year ending December 31, 1954	800

[1] The entire tax of $1,200 for the year ended June 30, 1954, was deductible in the return for 1953, since such tax accrued on July 1, 1953.

Year ending December 31, 1955

January through June 1955 (6/12 of $1,600)	$800
July through December 1955 (6/12 of $1,800)	900
Deduction for year ending December 31, 1955	1,700

Example (3). A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461 (c), such taxes, which relate to the calendar year 1954, are accruable on December 1 of the preceding calendar year. No deduction for real property taxes is allowable for the taxable year 1954 since such taxes accrued in the taxable year 1953 under section 23 (c) of the Internal Revenue Code of 1939.

Example (4). A taxpayer on an accrual method reports his taxable income for the taxable year ending March 31. He elects to accrue real property taxes ratably for the taxable year ending March 31, 1955. In the absence of an election under section 461 (c), such taxes are accruable on June 1 of the calendar year to which they relate. The real property taxes are $1,200 for 1954; $1,600 for 1955; and $1,800 for 1956. Deductions for such taxes for the taxable years ending March 31, 1955, and March 31, 1956, are computed as follows:

Fiscal year ending March 31, 1955

April through December 1954 (9/12 of $1,200)	$900
January through March 1955 (3/12 of $1,600)	400
Taxes accrued ratably in fiscal year ending March 31, 1955	1,300
Tax relating to period January through March 1954, paid in June 1954, and not deductible in prior taxable years (3/12 of $1,200)	300
Deduction for fiscal year ending March 31, 1955	1,600

Fiscal year ending March 31, 1956

April through December 1955 (9/12 of $1,600)	$1,200
January through March 1956 (3/12 of $1,800)	450
Deduction for fiscal year ending March 31, 1956	1,650

§ 1.462 Statutory provisions; reserves for estimated expenses.

SEC. 462. *Reserves for estimated expenses, etc.*—(a) *General rule.* In computing taxable income for the taxable year, there shall be taken into account (in the discretion of the Secretary or his delegate) a reasonable addition to each reserve for estimated expenses to which this section applies.

(b) *Adjustments where reserve becomes excessive.* If it is determined that the amount of any reserve for estimated expenses to which this section applies is (as of the close of the taxable year) excessive, then (under regulations prescribed by the Secretary or his delegate) such excess shall be taken into account in computing taxable income for the taxable year.

(c) *Estimated expenses to which this section applies*—(1) *Election of benefits.* This section shall apply to estimated expenses if and only if the taxpayer makes an election under this section with respect to the trade or business to which such expenses are attributable. The election shall be made in such manner as the Secretary or his delegate may by regulations prescribe. No election may be made with respect to a trade or business if in computing taxable income the cash receipts and disbursements method of accounting is used with respect to such trade or business.

(2) *Scope of election.* An election made under this section shall apply to all estimated expenses attributable to the trade or business.

(3) *When election may be made*—(A) *Without consent.* A taxpayer may, without the consent of the Secretary or his delegate, make an election under this section for his first taxable year (i) which begins after December 31, 1953, and ends after the date on which this title is enacted, and (ii) for which there are estimated expenses attributable to the trade or business. Such an election shall be made not later than the time prescribed by law for filing the return for such year (including extensions thereof).

(B) *With consent.* A taxpayer may, with the consent of the Secretary or his delegate, make an election under this section at any time.

(d) *Estimated expense defined*—(1) *General rule.* For purposes of this section, the term "estimated expense" means a deduction allowable by this subtitle—

(A) Part or all of which would (but for this section) be required to be taken into account for a subsequent taxable year;

(B) Which is attributable to the income of the taxable year or prior taxable years for which an election under this section is in effect; and

(C) Which the Secretary or his delegate is satisfied can be estimated with reasonable accuracy.

(2) *Exceptions.* The term "estimated expense" does not include—

(A) Any deduction attributable to income taken into account in computing taxable income for taxable years preceding the first taxable year for which the election is made;

(B) Any deduction attributable to prepaid income to which section 452 applies by rea-

(B) *With consent.* A taxpayer may, with the consent of the Secretary or his delegate, make an election under this subsection at any time.

§ 1.461–1 General rule for taxable year of deduction.

(a) *General rule*—(1) *Taxpayer using cash receipts and disbursements method.* Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) *Taxpayer using an accrual method.* Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

(3) *Other factors which determine when deductions may be taken.* (i) Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year cannot be used to reduce the income of a subsequent year. A taxpayer may not take advantage in a return for a subsequent year of his failure to claim deductions in a prior taxable year in which such deductions should have been properly taken under his method of accounting. If a taxpayer ascertains that a deduction should have been claimed in a prior taxable year, he should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arisng therefrom. Similarly, if a taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account.

(ii) Where there is a dispute and the entire liability is contested, judgments on account of damages for patent infringement, personal injuries or other causes, or other binding adjudications, including decisons of referees and boards of review under workmen's compensation laws, are deductions from gross income when the claim is finally adjudicated or is paid, depending upon the taxpayer's method of accounting. However, see subparagraph (2) of this paragraph.

(iii) For special rules relating to certain deductions, see the following sections and the regulations thereunder: Section 1481, relating to accounting for amounts repaid in connection with renegotiaton of a government contract; section 1341, relating to the computation of tax where the taxpayer repays a substantial amount received under a claim of right in a prior taxable year; and section 165 (e), relating to losses resulting from theft.

(4) *Deductions attributable to certain foreign income.* In any case in which, owing to monetary, exchange, or other restrictions imposed by a foreign country, an amount otherwise constituting gross income for the taxable year from sources without the United States is not includible in gross income of the taxpayer for that year, the deductions and credits properly chargeable against the amount so restricted shall not be deductible in such year but shall be deductible proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income. See paragraph (b) of § 1.905–1 for rules relating to credit for foreign income taxes when foreign income is subject to exchange controls.

(b) *Special rule in case of death.* A taxpayer's taxable year ends on the date of his death. See section 443 (a) (2) and paragraph (a) (2) of § 1.443–1. In computing taxable income for such year, there shall be deducted only amounts properly deductible under the method of accounting used by the taxpayer. However, if the taxpayer used an accrual method of accounting, no deduction shall be allowed for amounts accrued only by reason of his death. For rules relating to the inclusion of items of partnership deduction, loss, or credit in the return of a decedent partner, see subchapter K, chapter 1 of the Code, and the regulations thereunder.

(c) *Accrual of real property taxes*—(1) *In general.* If the accrual of real property taxes is proper in connection with one of the methods of accounting described in section 446 (c), any taxpayer using such a method of accounting may elect to accrue any real property tax, which is related to a definite period of time, ratably over that period in the manner described in this paragraph. For example, assume that such an election is made by a calendar-year taxpayer whose real property taxes, applicable to the period from July 1, 1955, to June 30, 1956, amount to $1,200. Under section 461 (c), $600 of such taxes accrue in the calendar year 1955, and the balance accrues in 1956. For general rules relating to deductions for taxes, see section 164 and the regulations thereunder.

(2) *Special rules*—(i) *Effective date.* Section 461 (c) and this paragraph do not apply to any real property tax allowable as a deduction under the Internal Revenue Code of 1939 for any taxable year beginning before January 1, 1954.

(ii) If real property taxes which relate to a period prior to the taxpayer's first taxable year beginning on or after January 1, 1954, would, but for section 461 (c), be deductible in such first taxable year, the portion of such taxes which applies to the prior period is deductible in such first taxable year (in addition to the amount allowable under section 461 (c) (1)).

(3) *When election may be made*—(i) *Without consent.* A taxpayer may elect to accrue real property taxes ratably in accordance with section 461 (c) and this paragraph without the consent of the Commissioner for his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in which the taxpayer incurs real property taxes. Such election must be made not later than the time prescribed by law for filing the return for such year (including extensions thereof). An election may be made by the taxpayer for each separate trade or business (and for nonbusiness activities, if accounted for separately). Such an election shall apply to all real property taxes of the trade, business, or nonbusiness activity for which the election is made. The election shall be made in a statement submitted with the taxpayer's return for the first taxable year to which the election is applicable. The statement should set forth:

(*a*) The trades or businesses, or nonbusiness activity, to which the election is to apply, and the method of accounting used therein;

(*b*) The period of time to which the taxes are related; and

(*c*) The computation of the deduction for real property taxes for the first year of the election (or a summary of such computation).

(ii) *With consent.* A taxpayer may elect with the consent of the Commissioner to accrue real property taxes ratably in accordance with section 461 (c) and this paragraph. A written re-

quest for permission to make such an election shall be submitted to the Commissioner of Internal Revenue, Washington 25, D. C., within 90 days after the beginning of the taxable year to which the election is first applicable, or before March 26, 1958, whichever date is later. The request for permission shall state:

(a) The name and address of the taxpayer;

(b) The trades or businesses, or nonbusiness activity, to which the election is to apply, and the method of accounting used therein;

(c) The taxable year to which the election first applies;

(d) The period to which the real property taxes relate;

(e) The computation of the deduction for real property taxes for the first year of election (or a summary of such computation); and

(f) An adequate description of the manner in which all real property taxes were deducted in the year prior to the year of election.

(4) *Binding effect of election.* An election to accrue real property taxes ratably under section 461 (c) is binding upon the taxpayer unless the consent of the Commissioner is obtained under section 446 (e) and paragraph (e) of § 1.446–1 to change such method of deducting real property taxes. If the last day prescribed by law for filing a return for any taxable year (including extensions thereof) to which section 461 (c) is applicable falls before March 25, 1958, consent is hereby given for the taxpayer to revoke an election previously made to accrue real property taxes in the manner prescribed by section 461 (c). If the taxpayer revokes his election under the preceding sentence, he must, on or before March 25, 1958, notify the district director for the district in which the return was filed of such revocation. For any taxable year for which such revocation is applicable, an amended return reflecting such revocation shall be filed on or before March 25, 1958.

(5) *Apportionment of taxes on real property between seller and purchaser.* For apportionment of taxes on real property between seller and purchaser, see section 164 (d) and the regulations thereunder.

(6) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). A taxpayer on an accrual method reports his taxable income for the taxable year ending June 30. He elects to accrue real property taxes ratably for the taxable year ending June 30, 1955 (which is his first taxable year beginning on or after January 1, 1954). In the absence of an election under section 461 (c), such taxes would accrue on January 1 of the calendar year to which they are related. The real property taxes are $1,200 for 1954; $1,600 for 1955; and $1,800 for 1956. Deductions for such taxes for the fiscal years ending June 30, 1955, and June 30, 1956, are computed as follows:

Fiscal year ending June 30, 1955

July through December 1954	[1]None
January through June 1955 (6/12 of $1,600)	$800
Deduction for fiscal year ending June 30, 1955	800

Fiscal year ending June 30, 1956

July through December 1955 (6/12 of $1,600)	$800
January through June 1956 (6/12 of $1,800)	900
Deduction for fiscal year ending June 30, 1956	1,700

[1] The taxes for 1954 were deductible in the fiscal year ending June 30, 1954, since such taxes accrued on January 1, 1954.

Example (2). A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461 (c), such taxes would accrue on July 1 and are assessed for the 12-month period beginning on that date. The real property taxes assessed for the year ending June 30, 1954, are $1,200; $1,600 for the year ending June 30, 1955; and $1,800 for the year ending June 30, 1956. Deductions for such taxes for the calendar years 1954 and 1955 are computed as follows:

Year ending December 31, 1954

January through June 1954	[1]None
July through December 1954 (6/12 of $1,600)	$800
Deduction for year ending December 31, 1954	800

[1] The entire tax of $1,200 for the year ended June 30, 1954, was deductible in the return for 1953, since such tax accrued on July 1, 1953.

Year ending December 31, 1955

January through June 1955 (6/12 of $1,600)	$800
July through December 1955 (6/12 of $1,800)	900
Deduction for year ending December 31, 1955	1,700

Example (3). A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461 (c), such taxes, which relate to the calendar year 1954, are accruable on December 1 of the preceding calendar year. No deduction for real property taxes is allowable for the taxable year 1954 since such taxes accrued in the taxable year 1953 under section 23 (c) of the Internal Revenue Code of 1939.

Example (4). A taxpayer on an accrual method reports his taxable income for the taxable year ending March 31. He elects to accrue real property taxes ratably for the taxable year ending March 31, 1955. In the absence of an election under section 461 (c), such taxes are accruable on June 1 of the calendar year to which they relate. The real property taxes are $1,200 for 1954; $1,600 for 1955; and $1,800 for 1956. Deductions for such taxes for the taxable years ending March 31, 1955, and March 31, 1956, are computed as follows:

Fiscal year ending March 31, 1955

April through December 1954 (9/12 of $1,200)	$900
January through March 1955 (3/12 of $1,600)	400
Taxes accrued ratably in fiscal year ending March 31, 1955	1,300
Tax relating to period January through March 1954, paid in June 1954, and not deductible in prior taxable years (3/12 of $1,200)	300
Deduction for fiscal year ending March 31, 1955	1,600

Fiscal year ending March 31, 1956

April through December 1955 (9/12 of $1,600)	$1,200
January through March 1956 (3/12 of $1,800)	450
Deduction for fiscal year ending March 31, 1956	1,650

§ 1.462 Statutory provisions; reserves for estimated expenses.

SEC. 462. *Reserves for estimated expenses, etc.*—(a) *General rule.* In computing taxable income for the taxable year, there shall be taken into account (in the discretion of the Secretary or his delegate) a reasonable addition to each reserve for estimated expenses to which this section applies.

(b) *Adjustments where reserve becomes excessive.* If it is determined that the amount of any reserve for estimated expenses to which this section applies is (as of the close of the taxable year) excessive, then (under regulations prescribed by the Secretary or his delegate) such excess shall be taken into account in computing taxable income for the taxable year.

(c) *Estimated expenses to which this section applies*—(1) *Election of benefits.* This section shall apply to estimated expenses if and only if the taxpayer makes an election under this section with respect to the trade or business to which such expenses are attributable. The election shall be made in such manner as the Secretary or his delegate may by regulations prescribe. No election may be made with respect to a trade or business if in computing taxable income the cash receipts and disbursements method of accounting is used with respect to such trade or business.

(2) *Scope of election.* An election made under this section shall apply to all estimated expenses attributable to the trade or business.

(3) *When election may be made*—(A) *Without consent.* A taxpayer may, without the consent of the Secretary or his delegate, make an election under this section for his first taxable year (i) which begins after December 31, 1953, and ends after the date on which this title is enacted, and (ii) for which there are estimated expenses attributable to the trade or business. Such an election shall be made not later than the time prescribed by law for filing the return for such year (including extensions thereof).

(B) *With consent.* A taxpayer may, with the consent of the Secretary or his delegate, make an election under this section at any time.

(d) *Estimated expense defined*—(1) *General rule.* For purposes of this section, the term "estimated expense" means a deduction allowable by this subtitle—

(A) Part or all of which would (but for this section) be required to be taken into account for a subsequent taxable year;

(B) Which is attributable to the income of the taxable year or prior taxable years for which an election under this section is in effect; and

(C) Which the Secretary or his delegate is satisfied can be estimated with reasonable accuracy.

(2) *Exceptions.* The term "estimated expense" does not include—

(A) Any deduction attributable to income taken into account in computing taxable income for taxable years preceding the first taxable year for which the election is made;

(B) Any deduction attributable to prepaid income to which section 452 applies by rea-

son of an election made under such section by the taxpayer; or

(C) Any deduction allowable under section 166 (relating to bad debts).

(e) *Special rule for deductions attributable to period before election.* Any deduction attributable to income taken into account in computing taxable income for taxable years preceding the first taxable year for which the election is made shall be allowable in the same manner and to the same extent as if this section had not been enacted.

[Sec. 462 repealed by Act of June 15, 1955 (Pub. Law 74, 84th Cong., 69 Stat. 134). For regulations under Pub. Law 74, see §§ 1.9000–1 through 1.9000–8.][1]

§ 1.462–1 Reserves for estimated expenses.

(a) *In general.* (1) Ordinarily, in computing taxable income expenses are not deductible for a taxable year prior to the taxable year in which paid or incurred, or paid or accrued, depending upon the taxpayer's method of accounting. However, section 462 permits a taxpayer, in the discretion of the Commissioner, to deduct a reasonable addition to a reserve for certain expenses (designated as estimated expenses), which, in the opinion of the Commissioner, can be estimated with reasonable accuracy. The general purpose of section 462 is to bring tax accounting more closely into harmony with generally accepted accounting principles; it is not intended to permit taxpayers to deduct an addition to a reserve for estimated expenses in any taxable year unless such treatment would be proper for such year under the taxpayer's method of accounting. The election under section 462 may be made with respect to any trade or business of the taxpayer provided that the cash receipts and disbursements method of accounting is not used in computing the taxable income of such trade or business, and the election shall apply to all estimated expenses of such trade or business.

(2) Section 446 provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 462 provides a specific method of accounting and, accordingly, the books of the taxpayer must be kept in accordance with such method if taxable income is to be computed under the method so elected. In computing taxable income, no amount shall be taken into account with respect to estimated expenses under section 462 unless a reserve therefor has been established and is properly recorded on the regular books of account which are used in computing the taxpayer's income and on the basis of which the taxpayer prepares his financial statements (such as reports to creditors, stockholders, etc.). If a taxpayer closes such books for the taxable year without making the necessary entries thereon to establish and record the reserve, and issues his financial statements on the basis of the books as so closed, any such entries made thereafter will not be deemed to meet the requirements of the preceding sentence with respect to such taxable year; however, this rule is not applicable in the case of a taxpayer who has closed his books and issued financial statements for the taxable year before January 24, 1955, if he makes the necessary entries before making the election under section 462(c)(3)(A) and paragraph (a) of § 1.462–4. In the case of a taxpayer (such as a regulated public utility defined in section 1503(c)) which is required by the rules of a governmental agency to maintain its books in accordance with a method of accounting different from that permitted by section 462, the method of accounting permitted by section 462 may be reflected in auxiliary records which shall be kept with, and reconciled with, the taxpayer's regular books.

(3) For applicable definitions, see section 462(d) and § 1.462–5.

(b) *Reasonable additions.* (1) Whether an addition to a reserve for estimated expenses is reasonable shall be determined in each particular case in the light of the pertinent facts known at the close of the taxable year. Among such pertinent facts to be considered is the experience of the taxpayer. However, in cases where the taxpayer has no such experience or his experience is inadequate, the experience of a taxpayer or group of taxpayers in a similar trade or business operating under similar conditions may be used if the taxpayer establishes to the satisfaction of the Commissioner that such experience is representative of the taxpayer's business. In case actual expenses prove to be more or less than those estimated in arriving at an addition to the reserve for prior years, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of a reasonable addition for the current taxable year.

(2) A taxpayer claiming deductions on account of additions to reserves for estimated expenses shall, with respect to each reserve for estimated expenses, attach to his tax return for the taxable year a statement disclosing a summary of his experience with respect to such expenses for the taxable year and the four preceding taxable years. Ordinarily, the taxpayer's experience for such a period will be an acceptable basis for computing the addition to the reserve. If, however, the taxpayer's experience does not extend over such period, the statement should disclose that fact and give a summary of the taxpayer's experience with respect to such expenses. This statement shall include the following information for the taxable year and each of such preceding taxable years: (i) A description of each expense, (ii) taxable income (loss), (iii) the amount added to the reserve, (iv) the amount charged against the reserve, (v) the balance in the reserve as of the end of the taxable year, (vi) the amount deducted from income for such expenses in taxable years in which a reserve was not maintained, and (vii) the name and amount of the item to which the experience ratio is applied in determining the amount of the reasonable addition, such as credit sales, net sales, gross income, etc.

(3) The following example will serve to illustrate the provisions of this paragraph:

Example. A taxpayer, using an accrual method of accounting, who sells appliances subject to a warranty, elects to deduct additions to a reserve for expenses which he estimates will be necessary to fulfill his obligation under the warranty on appliances sold during 1954. The taxpayer has not, prior to the election, maintained such a reserve on his books. The statement attached to his return shows:

APPLIANCE WARRANTY EXPENSES

Taxable year	Net sales	Taxable income	Addition to reserve	Charges to reserve	Balance in the reserve	Actual expenses
1950	$100,000	$15,000	-------	-------	------	$900
1951	110,000	16,000	-------	-------	------	1,100
1952	125,000	18,000	-------	-------	------	1,450
1953	150,000	17,000	-------	-------	------	1,550
1954	165,000	20,000	[1] $1,650	[2] $700	$950	[2] 700 [3] 800
Totals	650,000	-------	-------	-------	------	6,500

[1] Since the total of actual expenses for the most recent five years' experience amounts to 1 percent of the most recent five years' net sales, a reasonable addition to the reserve for 1954 would be 1 percent of $165,000 or $1,650. The amount deductible in 1954 is $2,450, composed of the addition to the reserve of $1,650 plus $800 actual expense attributable to sales of years prior to 1954 (allowable without regard to this section).

[2] Actual expense applicable to 1954 sales.

[3] Applicable to sales of years prior to 1954.

While in this example net sales have been used as a basis upon which the addition to the reserve is calculated, it should be understood that other items may be applicable under other circumstances and therefore such items should be substituted where appropriate.

(4) If the taxpayer has no experience with this type of expense, the statement shall include a complete description of the basis used in computing the addition to the reserve. In any event, the addition to the reserve is subject to the approval of the Commissioner upon subsequent examination of the return.

(5) In any case, the statement and accompanying data shall set forth for the taxable year such information as is necessary in order to establish clearly that (i) the reserve is one for which an addition is allowable under section 462 in computing taxable income, (ii) the amount of the addition is reasonable, and (iii) the amount of the reserve at the end of the taxable year is not excessive. The reserves to which section 462 applies shall be segregated from any reserves which may have been established by the taxpayer for taxable years prior to the taxable year for which the election under that section is exercised.

§ 1.462–2 Adjustments where reserve becomes excessive.

In any case in which a reserve for estimated expenses as of the close of any taxable year is determined to be excessive, such excess shall be taken

[1] Sections 1.462 through 1.462–7, included in this republication, will not be carried in the Code of Federal Regulations.

into account in computing the taxable income for the taxable year for which such determination is made. For example, if for the taxable year ending December 31, 1956, it is determined by the Commissioner that a reserve (including a claimed addition for the year 1956) is excessive, such excess shall be taken into account in computing taxable income for the year 1956. In any case in which it is determined that a particular reserve for estimated expenses is no longer necessary, the amount of the reserve as of the close of the taxable year for which such determination is made shall be taken into account in computing the taxable income for such year. Similarly, in any case in which the use of reserves for estimated expenses is discontinued, the balance of each such reserve shall be included in taxable income for the year of change.

§ 1.462–3 Election of benefits.

(a) The election referred to in § 1.462–1 shall apply to all estimated expenses attributable to the trade or business to which the election is applicable both for the taxable year for which the election is made and for all subsequent taxable years unless a change to a different method is authorized by the Commissioner under the provisions of section 446. However, the election does not apply to any estimated expenses which are attributable to prepaid income deferred at the close of the taxable year under the provisions of section 452. If the taxpayer is engaged in more than one trade or business, he may make a separate election with respect to each such trade or business.

(b) In no event shall an election under section 462 be applicable in the computation of taxable income for any taxable year preceding the taxable year for which such election is made. Such an election cannot be made for any taxable year beginning before January 1, 1954, or ending before August 17, 1954.

(c) No election shall be permitted with respect to a trade or business if the cash receipts and disbursements method of accounting is used in computing taxable income or if, under a combination of methods, the cash receipts and disbursements method is used in reporting items other than items of gross income for income tax purposes for such trade or business.

(d) If the taxpayer clearly evidences a bona fide intent to comply with the provisions of section 462 and the regulations thereunder, his election under that section will not be invalidated by:

(i) His failure to take into account certain estimated expenses in establishing his reserve;

(ii) His failure correctly to determine the amount of any such reserve or additions thereto; or

(iii) His establishment of a reserve for an expense to which section 462 does not apply.

§ 1.462–4 Time and manner of making election.

(a) *Without consent.* The election under section 462 may be made without the consent of the Commissioner if made for the first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in which there are estimated expenses of the particular trade or business for which the election is made. The election must be made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The election shall be made in a statement attached to the taxpayer's return for the first taxable year to which the election is applicable. Such statement shall contain the information required by paragraph (c) of this section.

(b) *With consent.* (1) If a taxpayer does not make the election under paragraph (a) he may elect the benefits of section 462 for his second taxable year beginning after December 31, 1953, and ending after August 16, 1954, provided that on or before June 30, 1955, he notifies the Commissioner of Internal Revenue, Washington 25, D.C., of his intention to make such election. The notification shall state that the taxpayer has not elected the benefits of section 462 for his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, but desires to elect the benefits of such section for the next succeeding taxable year. The notification shall be in triplicate, shall identify the trade or business to which the election is to apply, shall show the name and address of the taxpayer and the district in which the return of the taxpayer is to be filed. In such a case the taxpayer's notification will be treated as an election to have the benefits of section 462 apply to such taxable year and to all subsequent taxable years. A copy of the notification will be stamped with the approval of the Commissioner and returned to the taxpayer. Such copy, together with a statement containing the information required by paragraph (c) of this section, shall be attached to the return for the first taxable year to which the election applies.

(2) In the event that a taxpayer does not make an election under paragraph (a) of this section or subparagraph (1) of this paragraph, he may, at a later date, elect the benefits of the provisions of section 462 only if he obtains the consent of the Commissioner. In such a case, a written request for consent shall be made to the Commissioner not later than 90 days after the beginning of the first taxable year for which the election is applicable or 90 days after the date of promulgation of the regulations under section 462, whichever is later. Such request shall contain the information set forth in paragraph (c) of this section.

(c) *Information required.* The statement or request filed under paragraph (a) or (b) of this section shall set forth the following:

(1) The name and description of each trade or business to which the election is to apply;

(2) A declaration that the election is intended to apply to all estimated expenses of the trade or business;

(3) The method of accounting used by the taxpayer in such trade or business;

(4) A description of each type of estimated expenses of such trade or business;

(5) Whether a previous election under the provisions of section 462 has been made for such trade or business and, if so, for what taxable years such election was in effect; and

(6) The name and description of each trade or business, if any, to which the election does not apply.

§ 1.462–5 Estimated expense defined.

(a) *General rule.* For purposes of section 462(a) (which provides that there shall be taken into account in the discretion of the Secretary or his delegate a reasonable addition to each reserve for estimated expenses to which section 462 applies), the term "estimated expense" means a deduction which:

(1) Is allowable in computing taxable income;

(2) Is attributable to income of the taxable year or of prior taxable years for which an election under section 462 is in effect;

(3) In the opinion of the Commissioner can be estimated with reasonable accuracy; and

(4) Is a deduction, a part or all of which would be required, except for section 462, to be taken into account for a subsequent taxable year.

(b) *Exceptions.* The term "estimated expense" does not include any deduction which is:

(1) Attributable to income taken into account in computing taxable income for taxable years preceding the first taxable year for which the election is made;

(2) Attributable to income deferred as of the close of the taxable year under section 452; or

(3) Allowable under section 166, relating to bad debts.

(c) *Rules for application of paragraphs (a) and (b) of this section.* (1) Estimated expenses are those which are attributable to a transaction or undertaking in the taxable year or a prior taxable year under which:

(i) Income is realized which is includible in income for the taxable year or a prior taxable year; and

(ii) The taxpayer is under a liability to perform service, furnish goods, supply property, or assume obligations, which necessitate the making of expenditures by the taxpayer during a subsequent taxable year.

(2) Expenses attributable to income of future years are not expenses for which an addition to a reserve under section 462 is allowable. An expenditure to be made in a year subsequent to the taxable year is not attributable to the income of the taxable year or prior taxable years merely because it is incurred in order to restore operating or productive capacity which has been diminished by the operations of the taxable year or prior taxable years.

(3) The following examples illustrate the application of paragraphs (a) and (b) of this section: If the taxpayer, as an incentive or inducement to employment, offers vacations for faithful service, amounts to be expended for such purpose may be estimated expenses within the meaning of section 462. Likewise, if the taxpayer, in order to promote sales or to encourage prompt pay-

ment for articles sold, agrees to keep the product sold in repair for subsequent years or offers cash discounts, amounts set aside for these purposes may constitute estimated expenses. However, that term does not include expenses for maintenance and repairs unless the taxpayer is under a liability to make repairs or incur maintenance expenses in a subsequent taxable year as a condition to the realization of income in the taxable year. For example, if, as a condition to obtaining machinery under a rental contract, the taxpayer is required to make certain periodic repairs in subsequent taxable years, an addition to a reserve to meet the costs thereof may be estimated expenses within the meaning of section 462. Further, the cost of repairs to delivery equipment used to fulfill an obligation under the taxpayer's warranty agreement to keep a product in repair or in service may be treated as an estimated expense. On the other hand, estimated costs of repairs and maintenance to the taxpayer's property may not be considered estimated expenses to which the provisions of section 462 apply unless such costs are undertaken pursuant to a liability to another person as a condition to the realization of income.

(4) Reserves created for general undetermined contingencies, for indefinite possible future losses, for expenses and losses not reasonably related to the income of the taxable year or prior taxable years, or for expenses and losses that are being contested or are in litigation, cannot ordinarily be estimated with reasonable accuracy and may not be the basis for additions to reserves for estimated expenses. With respect to items involving related reserves, only one deduction against taxable income will be allowed. Section 462 does not have the effect of converting into deductible expenses amounts which would not otherwise be deductible in computing taxable income for subsequent taxable years. The provisions of section 462 have no application with respect to the renegotiation or price redetermination of contracts.

(5) Section 462 is not applicable to any item of deduction for which the Code provides a specific method of reporting such as deductions referred to in—

(i) Section 404, relating to contributions of an employer to an employee's trust or annuity plan and compensation under a deferred payment plan,

(ii) Section 461(c), relating to accrual of real property taxes,

(iii) Section 174, relating to research and experimental expenditures,

(iv) Section 175, relating to soil and water conservation expenditures,

(v) Section 615, relating to exploration expenditures, and

(vi) Section 616, relating to development expenditures.

(6) Examples of expenses which ordinarily meet the requirements of this section are cash discounts, product warranties, sales returns and allowances, freight allowances, quantity discounts, vacation pay, and self-insurance by common carriers for liability for cargo damages. Examples of expenses which ordinarily do not meet the requirements of this section are inventory adjustments, self-insurance for losses of the taxpayer's own property, franchise and other taxes levied for a period subsequent to the taxable year, and fees for professional services not yet rendered.

§ 1.462–6 Special rule for deductions attributable to period before election.

Any deduction attributable to income taken into account in computing taxable income for taxable years preceding the first taxable year for which the election is made shall be allowable in the same manner, and to the same extent, as if section 462 had not been enacted. For example, merchandise returned in 1954, attributable to sales made in 1953 (the year prior to the election), will be taken into account in 1954 as returned sales, even though for 1954 the taxpayer has elected to deduct a reasonable addition to reserves for estimated expenses. See the example in paragraph (b)(3) of § 1.462–1.

§ 1.462–7 Examples.

The following examples illustrate the provisions of the regulations under section 462:

Example (1). A taxpayer who has elected the benefits of section 462 sells air-conditioning units which he guarantees for one year. Taxpayer's experience indicates that the average cost per unit of fulfilling the guarantee is as follows:

Material and parts	$8
Labor	12
Operating overhead	4
Total	24

For each unit sold $24.00 shall be credited to the reserve account. As expenses are actually incurred, the reserve shall be charged with the amount of these expenses. In no event will a double deduction be permitted. At the close of each taxable year the reserve shall be adjusted to reflect changes in the actual cost experience of the taxpayer.

Example (2). A calendar year taxpayer who has elected the benefits of section 462 estimates from past experience that 1 percent of all sales will be returned for credit and that one-half of the returns applicable to any month's sales will be returned during that month and one-half during the following month. Gross sales for the month of December 1954 totaled $1,000,000. Cost of December's sales amount to $700,000. A reasonable addition to a reserve for sales returns as of December 31, 1954, is calculated as follows:

Gross sales for December	$1,000,000
Cost of sales for December	700,000
Gross profit for December	300,000
Reasonable addition (1 percent of ½ of $300,000)	1,500

Example (3). A taxpayer, engaged in the business of transporting property for hire, has elected the benefits of section 462 for the taxable year 1954, and has established a proper reserve for claims for property damaged while in transit. The reserve for property damage claims at the beginning of the taxable year 1955 carries a credit balance of $15,000. His experience shows that 1 percent of his gross revenues will be paid out to meet claims for property damaged while in transit. For the taxable year 1955 he has gross revenue of $2,000,000. A reasonable addition to this reserve for the taxable year 1955 is 1 percent of $2,000,000 or $20,000. An analysis of the reserve for the year 1955 is as follows:

Balance in reserve at beginning of year	$15,000
Claims paid during the year	17,000
Excess of charges over credits	(2,000)
Current year's addition allowed as deduction	20,000
Balance at end of year	18,000

INVENTORIES

§ 1.471 Statutory provisions; general rule for inventories.

SEC. 471. *General rule for inventories.* Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

§ 1.471–1 Need for inventories.

In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see § 1.472–1.)

§ 1.471–2 Valuation of inventories.

(a) Section 471 provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with §§ 1.471–1 through 1.471–9. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can,

as a general rule, be regarded as clearly reflecting his income.

(c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower. (For inventories by dealers in securities, see § 1.471–5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

(d) In respect of normal goods, whichever method is adopted must be applied with reasonable consistency to the entire inventory of the taxpayer's trade or business except as to those goods inventoried under the last-in, first-out method authorized by section 472 or to animals inventoried under the elective unit-livestock-price-method authorized by § 1.471–6. See paragraph (d) of § 1.446–1 for rules permitting the use of different methods of accounting if the taxpayer has more than one trade or business. Where the taxpayer is engaged in more than one trade or business the Commissioner may require that the method of valuing inventories with respect to goods in one trade or business also be used with respect to similar goods in other trades or businesses if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income. Taxpayers were given an option to adopt the basis of either (1) cost or (2) cost or market, whichever is lower, for their 1920 inventories. The basis properly adopted for that year or any subsequent year is controlling, and a change can now be made only after permission is secured from the Commissioner. Application for permission to change the basis of valuing inventories shall be made in writing and filed with the Commissioner as provided in paragraph (e) of § 1.446–1. Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired. But see section 472 as to last-in, first-out inventories. Where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

(e) Inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. The inventories of taxpayers on whatever basis taken will be subject to investigation by the district director, and the taxpayer must satisfy the district director of the correctness of the prices adopted.

(f) The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with the regulations in this part:

(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(3) Omitting portions of the stock on hand.

(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

(5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

§ 1.471–3 Inventories at cost.

Cost means:

(a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(b) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, (3) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

(d) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. Among such cases are: (1) Farmers and raisers of livestock (see § 1.471–6); (2) miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike (see § 1.471–7); and (3) retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see § 1.471–8).

§ 1.471–4 Inventories at cost or market, whichever is lower.

(a) Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—

(1) Of goods purchased and on hand, and

(2) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i. e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss, which goods must be inventoried at cost.

(b) Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

(c) Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

§ 1.471–5 Inventories by dealers in securities.

A dealer in securities who in his books of account regularly inventories unsold securities on hand either—

(a) At cost,

(b) At cost or market, whichever is lower, or

(c) At market value,

may make his return upon the basis upon which his accounts are kept, provided that a description of the method employed is included in or attached to the return, that all the securities are inventoried by the same method, and that such method is adhered to in subsequent years, unless another method is authorized by the Commissioner pursuant to a written application therefor filed as provided in paragraph (e) of § 1.446–1. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this section, as regularly inventorying his securities at cost. For the purposes of this section, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as provided in this section may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this section.

§ 1.471–6 Inventories of livestock raisers and other farmers.

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of § 1.446–1.

(b) In any change of accounting method from the cash receipts and disbursements method to an inventory method, adjustments shall be made as provided in section 481 (relating to adjustments required by change in method of accounting) and the regulations thereunder.

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory method may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock-price method".

(d) The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446–1.

(e) The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the district director upon examination of the taxpayer's return.

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

(g) A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in, first-out method of valuing inventories must be applied.

(h) If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446–1. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock without formal application for permission, but the classifications and unit prices selected are subject to approval by the district director upon examination of the taxpayer's return. A livestock raiser who has adopted a constant unit-price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the "unit-livestock-price method".

(i) If returns have been made in which the taxable income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding taxable year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding taxable year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

§ 1.471–7 Inventories of miners and manufacturers.

A taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product, which in the aggregate will absorb the total cost of production, may, with the consent of the Commissioner, use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds, sizes, or grades of product. See section 472 as to last-in, first-out inventories.

§ 1.471–8 Inventories of retail merchants.

(a) Retail merchants who employ what is known as the "retail method" of pricing inventories may make their returns upon that method, provided that the use of such method is designated upon the return, that accurate accounts are kept, and that such method is consistently adhered to unless a change is authorized by the Commissioner as provided in paragraph (e) of § 1.446–1. Under the retail method the total of the retail selling prices of the goods on hand at the end of the year in each department or of each class of goods is reduced to approximate cost by deducting therefrom an amount which bears the same ratio to such total as—

(1) The total of the retail selling prices of the goods included in the opening inventory plus the retail selling prices of the goods purchased during the year, with proper adjustment to such selling prices for all mark-ups and mark-downs, less

(2) The cost of the goods included in the opening inventory plus the cost of the goods purchased during the year, bears to (1).

The result should represent as accurately as may be the amounts added to the cost price of the goods to cover selling and other expenses of doing business and for the margin of profit.

(b) For further adjustments to be made in the case of a retail merchant using the last-in, first-out inventory method authorized by section 472, see paragraph (k) of § 1.472–1.

(c) A taxpayer maintaining more than one department in his store or dealing in classes of goods carrying different percentages of gross profit should not use a percentage of profit based upon an average of his entire business, but should compute and use in valuing his inventory the proper percentages for the respective departments or classes of goods.

(d) A taxpayer (other than one using the last-in, first-out inventory method) who previously has determined inventories in accordance with the retail method, except that, to obtain a basis of approximate cost or market, whichever is lower, has consistently and uniformly followed the practice of adjusting the retail selling prices of the goods included in the opening inventory and purchased during the taxable year for mark-ups but not for mark-downs, may continue such practice subject to the conditions prescribed in this section. The adjustments must be bona fide and consistent and uniform. Where mark-downs are not included in the adjustments, mark-ups made to cancel or correct mark-downs shall not be included; and the mark-ups included must be reduced by the mark-downs made to cancel or correct such mark-ups.

(e) In no event shall mark-downs not based on actual reduction of retail sale prices, such as mark-downs based on depreciation and obsolescence, be recognized in determining the retail selling prices of the goods on hand at the end of the taxable year.

(f) A taxpayer (other than one using the last-in, first-out inventory method) who previously has determined inventories without following the practice of eliminating mark-downs in making adjustments to retail selling prices may adopt such practice, provided permission to do so is obtained in accordance with, and subject to the terms provided by, paragraph (e) of § 1.446–1. A taxpayer filing a first return of income may adopt such practice subject to approval by the district director upon examination of the return.

(g) A taxpayer using the last-in, first-out inventory method in conjunction with retail computations must adjust retail selling prices for mark-downs as well as mark-ups, in order that there may be reflected the approximate cost of the goods on hand at the end of the taxable year regardless of market values.

§ 1.471–9 Inventories of acquiring corporations.

For additional rules in the case of certain corporate acquisitions specified in section 381(a), see section 381(c)(5) and the regulations thereunder.

§ 1.472 Statutory provisions; last-in, first-out inventories.

SEC. 472. *Last-in, first-out inventories*—

(a) *Authorization.* A taxpayer may use the method provided in subsection (b) (whether or not such method has been prescribed under section 471) in inventorying goods specified in an application to use such method filed at such time and in such manner as the Secretary or his delegate may prescribe. The change to, and the use of, such method shall be in accordance with such regulations as the Secretary or his delegate may prescribe as necessary in order that the use of such method may clearly reflect income.

(b) *Method applicable.* In inventorying goods specified in the application described in subsection (a), the taxpayer shall:

(1) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof; and second, those acquired in the taxable year;

(2) Inventory them at cost; and

(3) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.

(c) *Condition.* Subsection (a) shall apply only if the taxpayer establishes to the satisfaction of the Secretary or his delegate that the taxpayer has used no procedure other than that specified in paragraphs (1) and (3) of subsection (b) in inventorying such goods to ascertain the income, profit, or loss of the first taxable year for which the method described in subsection (b) is to be used, for the purpose of a report or statement covering such taxable year—

(1) To shareholders, partners, or other proprietors, or to beneficiaries, or

(2) For credit purposes.

(d) *Preceding closing inventory.* In determining income for the taxable year preceding the taxable year for which the method described in subsection (b) is first used, the closing inventory of such preceding year of the goods specified in the application referred to in subsection (a) shall be at cost.

(e) *Subsequent inventories.* If a taxpayer, having complied with subsection (a), uses the method described in subsection (b) for any taxable year, then such method shall be used in all subsequent taxable years unless—

(1) With the approval of the Secretary or his delegate a change to a different method is authorized; or,

(2) The Secretary or his delegate determines that the taxpayer has used for any such subsequent taxable year some procedure other than that specified in paragraph (1) of subsection (b) in inventorying the goods specified in the application to ascertain the income, profit, or loss of such subsequent taxable year for the purpose of a report or statement covering such taxable year (A) to shareholders, partners, or other proprietors, or beneficiaries, or (B) for credit purposes; and requires a change to a method different from that prescribed in subsection (b) beginning with such subsequent taxable year or any taxable year thereafter.

If paragraph (1) or (2) of this subsection applies, the change to, and the use of, the different method shall be in accordance with such regulations as the Secretary or his delegate may prescribe as necessary in order that the use of such method may clearly reflect income.

(f) *Cross reference.* For provisions relating to involuntary liquidation and replacement of LIFO inventories, see section 1321.

§ 1.472–1 Last-in, first-out inventories.

(a) Any taxpayer permitted or required to take inventories pursuant to the provisions of section 471, and pursuant to the provisions of §§ 1.471–1 to 1.471–9, inclusive, may elect with respect to those goods specified in his application and properly subject to inventory to compute his opening and closing inventories in accordance with the method provided by section 472, this section, and § 1.472–2. Under this last-in, first-out (LIFO) inventory method, the taxpayer is permitted to treat those goods remaining on hand at the close of the taxable year as being:

(1) Those included in the opening inventory of the taxable year, in the order of acquisition and to the extent thereof, and

(2) Those acquired during the taxable year.

The LIFO inventory method is not dependent upon the character of the business in which the taxpayer is engaged, or upon the identity or want of identity through commingling of any of the goods on hand, and may be adopted by the taxpayer as of the close of any taxable year.

(b) If the LIFO inventory method is used by a taxpayer who regularly and consistently, in a manner similar to hedging on a futures market, matches purchases with sales, then firm purchases and sales contracts (i. e., those not legally subject to cancellation by either party) entered into at fixed prices on or before the date of the inventory may be included in purchases or sales, as the case may be, for the purpose of determining the cost of goods sold and the resulting profit or loss, provided that this practice is regularly and consistently adhered to by the taxpayer and provided that, in the opinion of the Commissioner, income is clearly reflected thereby.

(c) A manufacturer or processor who has adopted the LIFO inventory method as to a class of goods may elect to have such method apply to the raw materials only (including those included in goods in process and in finished goods) expressed in terms of appropriate units. If such method is adopted, the adjustments are confined to costs of the raw material in the inventory and the cost of the raw material in goods in process and in finished goods produced by such manufacturer or processor and reflected in the inventory. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Assume that the opening inventory had 10 units of raw material, 10 units of goods in process, and 10 units of finished goods, and that the raw material cost was 6 cents a unit, the processing cost 2 cents a unit, and overhead cost 1 cent a unit. For the purposes of this example, it is assumed that the entire amount of goods in process was 50 percent processed.

OPENING INVENTORY

	Raw material	Goods in process	Finished goods
Raw material	$0.60	$0.60	$0.60
Processing cost		.10	.20
Overhead		.05	.10

In the closing inventory there are 20 units of raw material, 6 units of goods in process,

and 8 units of finished goods and the costs were: Raw material 10 cents, processing cost 4 cents, and overhead 1 cent.

CLOSING INVENTORY

[Based on cost and prior to adjustment]

	Raw material	Goods in process	Finished goods
Raw material	$2.00	$0.60	$0.80
Processing costs		.12	.32
Overhead		.03	.08
Total	2.00	.75	1.20

There were 30 units of raw material in the opening inventory and 34 units in the closing inventory. The adjustment to the closing inventory would be as follows:

CLOSING INVENTORY AS ADJUSTED

	Raw material	Goods in process	Finished goods
Raw material:			
20 at 6 cents	$1.20		
6 at 6 cents		$0.36	
4 at 6 cents			$0.24
4 at 10 cents [1]			.40
Processing costs		.12	.32
Overhead		.03	.08
Total	1.20	.51	1.04

[1] This excess is subject to determination of price under section 472 (b) (1) and § 1.472-2. If the excess falls in goods in process, the same adjustment is applicable.

The only adjustment to the closing inventory is the cost of the raw material; the processing costs and overhead cost are not changed.

Example (2). Assume that the opening inventory had 5 units of raw material, 10 units of goods in process, and 20 units of finished goods, with the same prices as in example (1), and that the closing inventory had 20 units of raw material, 20 units of goods in process, and 10 units of finished goods, with raw material costs as in the closing inventory in example (1). The adjusted closing inventory would be as follows in so far as the raw material is concerned:

Raw material, 20 at 6 cents	$1.20
Goods in process:	
15 at 6 cents	.90
5 at 10 cents [1]	.50
Finished goods:	
None at 6 cents	.00
10 at 10 cents [1]	1.00

[1] This excess is subject to determination of price under section 472 (b) (1) and § 1.472-2.

The 20 units of raw material in the raw state plus 15 units of raw material in goods in process make up the 35 units of raw material that were contained in the opening inventory.

(d) For the purposes of this section, raw material in the opening inventory must be compared with similar raw material in the closing inventory. There may be several types of raw materials, depending upon the character, quality, or price, and each type of raw material in the opening inventory must be compared with a similar type in the closing inventory.

(e) In the cotton textile industry there may be different raw materials depending upon marked differences in length of staple, in color or grade of the cotton. But where different staple lengths or grades of cotton are being used at different times in the same mill to produce the same class of goods, such differences would not necessarily require the classification into different raw materials.

(f) As to the pork packing industry a live hog is considered as being composed of various raw materials, different cuts of a hog varying markedly in price and use. Generally a hog is processed into approximately 10 primal cuts and several miscellaneous articles. However, due to similarity in price and use, these may be grouped into fewer classifications, each group being classed as one raw material.

(g) When the finished product contains two or more different raw materials as in the case of cotton and rayon mixtures, each raw material is treated separately and adjustments made accordingly.

(h) Upon written notice addressed to the Commissioner of Internal Revenue, Attention T:R, Washington 25, D. C., by the taxpayer, a taxpayer who has heretofore adopted the LIFO inventory method in respect of any goods may adopt the method authorized in this section and limit the election to the raw material including raw materials entering into goods in process and in finished goods. If this method is adopted as to any specific goods, it must be used exclusively for such goods for any prior taxable year (not closed by agreement) to which the prior election applies and for all subsequent taxable years, unless permission to change is granted by the Commissioner.

(i) The election may also be limited to that phase in the manufacturing process where a product is produced that is recognized generally as a salable product as, for example, in the textile industry where one phase of the process is the production of yarn. Since yarn is generally recognized as a salable product, the election may be limited to that portion of the process when yarn is produced. In the case of copper and brass processors, the election may be limited to the production of bars, plates, sheets, etc., although these may be further processed into other products.

(j) The election may also apply to any one raw material, when two or more raw materials enter into the composition of the finished product; for example, in the case of cotton and rayon yarn, the taxpayer may elect to inventory the cotton only. However, a taxpayer who has previously made an election to use the LIFO inventory method may not later elect to exclude any raw materials that were covered by such previous election.

(k) If a taxpayer using the retail method of pricing inventories, authorized by § 1.471-8, elects to use in connection therewith the LIFO inventory method authorized by section 472 and this section, the apparent cost of the goods on hand at the end of the year, determined pursuant to § 1.471-8, shall be adjusted to the extent of price changes therein taking place after the close of the preceding taxable year. The amount of any apparent inventory increase or decrease to be eliminated in this adjustment shall be determined by reference to acceptable price indexes established to the satisfaction of the Commissioner. Price indexes prepared by the United States Bureau of Labor Statistics which are applicable to the goods in question will be considered acceptable to the Commissioner. Price indexes which are based upon inadequate records, or which are not subject to complete and detailed audit within the Internal Revenue Service, will not be approved.

(l) If a taxpayer uses consistently the so-called "dollar-value" method of pricing inventories, or any other method of computation established to the satisfaction of the Commissioner as reasonably adaptable to the purpose and intent of section 472 and this section, and if such taxpayer elects under section 472 to use the LIFO inventory method authorized by such section, the taxpayer's opening and closing inventories shall be determined under section 472 by the use of the appropriate adaptation.

§ 1.472-2 Requirements incident to adoption and use of LIFO inventory method.

Except as otherwise provided in § 1.472-1 with respect to raw material computations, with respect to retail inventory computations, and with respect to "dollar-value" and other methods of computation established to the satisfaction of the Commissioner as reasonably adapted to the purpose and intent of section 472, the adoption and use of the LIFO inventory method is subject to the following requirements:

(a) The taxpayer shall file an application to use such method specifying with particularity the goods to which it is to be applied.

(b) The inventory shall be taken at cost regardless of market value.

(c) Goods of the specified type included in the opening inventory of the taxable year for which the method is first used shall be considered as having been acquired at the same time and at a unit cost equal to the actual cost of the aggregate divided by the number of units on hand. The actual cost of the aggregate shall be determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the prior taxable year with the exception that restoration shall be made with respect to any writedown to market values resulting from the pricing of former inventories.

(d) Goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be included in the closing inventory, regardless of identification with specific invoices and regardless of specific cost accounting records, at costs determined pursuant to the provisions of subparagraph (1) or (2) of this paragraph, dependent upon the character of the transactions in which the taxpayer is engaged:

(1) (i) In the case of a taxpayer engaged in the purchase and sale of merchandise, such as a retail grocer or druggist, or engaged in the initial production of merchandise and its sale without processing, such as a miner selling his ore output without smelting or refining, such costs shall be determined—

(a) By reference to the actual cost of the goods most recently purchased or produced;

(b) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(c) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced, the goods reflected in such inventory increase being considered for the purposes of section 472 as having been acquired all at the same time; or

(d) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

(ii) Whichever of the several methods of valuing the inventory increase is adopted by the taxpayer and approved by the Commissioner shall be consistently adhered to in all subsequent taxable years so long as the LIFO inventory method is used by the taxpayer.

(iii) The application of subdivisions (i) and (ii) of this subparagraph may be illustrated by the following examples:

Example (1). Suppose that the taxpayer adopts the LIFO inventory method for the taxable year 1957 with an opening inventory of 10 units at 10 cents per unit, that it makes 1957 purchases of 10 units as follows:

January	1 at $0.11 =	$0.11
April	2 at .12 =	.24
July	3 at .13 =	.39
October	4 at .14 =	.56
Totals	10	1.30

and that it has a 1957 closing inventory of 15 units. This closing inventory, depending upon the taxpayer's method of valuing inventory increases, will be computed as follows:

(a) Most recent purchases—

10 at $0.10	$1.00
4 at .14 (October)	.56
1 at .13 (July)	.13
Totals 15	1.69

or

(b) In order of acquisition—

10 at $0.10	$1.00
1 at .11 (January)	.11
2 at .12 (April)	.24
2 at .13 (July)	.26
Totals 15	1.61

or

(c) At an annual average—

10 at $0.10	$1.00
5 at .13 (130/10)	.65
Totals 15	1.65

Example (2). Suppose that the taxpayer's closing inventory for 1958, the year following that involved in example (1) of this subdivision, reflects an inventory decrease for the year, and not an increase; suppose that there is, accordingly, a 1958 closing inventory of 13 units. Inasmuch as the decreased closing inventory will be determined wholly by reference to the 15 units reflected in the opening inventory for the year, and will be taken "in the order of acquistion" pursuant to section 472 (b) (1), and inasmuch as the character of the taxpayer's opening inventory for 1958 will be dependent upon its method of valuing its 5-unit inventory increase for 1957, the closing inventory for 1958 will be computed as follows:

(a) In case the increase for 1957 was taken by reference to the most recent purchases—

10 at $0.10 (from 1956)	$1.00
1 at .13 (July 1957)	.13
2 at .14 (October 1957)	.28
Totals 13	1.41

or

(b) In case the increase for 1957 was taken in the order of acquisition—

10 at $0.10 (from 1956)	$1.00
1 at .11 (January 1957)	.11
2 at .12 (April 1957)	.24
Totals 13	1.35

or

(c) In case the increase for 1957 was taken on the basis of an average—

10 at $0.10 (from 1956)	$1.00
3 at .13 (from 1957)	.39
Totals 13	1.39

(2) In the case of a taxpayer engaged in manufacturing, fabricating, processing, or otherwise producing merchandise, such costs shall be determined:

(i) In the case of raw materials purchased or initially produced by the taxpayer, in the manner elected by the taxpayer under subparagraph (1) of this paragraph to the same extent as if the taxpayer were engaged in purchase and sale transactions; and

(ii) In the case of goods in process, regardless of the stage to which the manufacture, fabricating, or processing may have advanced, and in the case of finished goods, pursuant to any proper method which, in the opinion of the Commissioner, clearly reflects income.

(e) The taxpayer shall establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining income, profit, or loss for the taxable year for which the LIFO inventory method is first used or for any subsequent taxable year, for credit purposes or for the purpose of reports to shareholders, partners, or other proprietors, or to beneficiaries, has not used any inventory method other than that referred to in § 1.472–1 or at variance with the requirement referred to in paragraph (c) of this section. The taxpayer's use of market value in lieu of cost or his issuance of reports or credit statements covering a period of operations less than the whole of the taxable year is not considered at variance with this requirement.

(f) Goods of the specified type on hand as of the close of the taxable year preceding the taxable year for which this inventory method is first used shall be included in the taxpayer's closing inventory for such preceding taxable year at cost determined in the manner prescribed in paragraph (c) of this section.

(g) The LIFO inventory method, once adopted by the taxpayer with the approval of the Commissioner, shall be adhered to in all subsequent taxable years unless—

(1) A change to a different method is approved by the Commissioner; or

(2) The Commissioner determines that the taxpayer, in ascertaining income, profit, or loss for the whole of any taxable year subsequent to his adoption of the LIFO inventory method, for credit purposes or for the purpose of reports to shareholders, partners, or other proprietors, or to beneficiaries, has used any inventory method at variance with that referred to in § 1.472–1 and requires of the taxpayer a change to a different method for such subsequent taxable year or any taxable year thereafter.

(h) The records and accounts employed by the taxpayer in keeping his books shall be maintained in conformity with the inventory method referred to in § 1.472–1; and such supplemental and detailed inventory records shall be maintained as will enable the district director readily to verify the taxpayer's inventory computations as well as his compliance with the requirements of section 472 and §§ 1.472–1 through 1.472–7.

(i) Where the taxpayer is engaged in more than one trade or business, the Commissioner may require that if the LIFO method of valuing inventories is used with respect to goods in one trade or business the same method shall also be used with respect to similar goods in the other trades or businesses if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income.

§ 1.472–3 Time and manner of making election.

(a) The LIFO inventory method may be adopted and used only if the taxpayer files with his income tax return for the taxable year as of the close of which the method is first to be used, in triplicate on Form 970, and pursuant to the instructions printed thereon and to the requirements of this section, a statement of his election to use such inventory method. Such statement shall be accompanied by an analysis of all inventories of the taxpayer as of the beginning and as of the end of the taxable year for which the LIFO inventory method is proposed first to be used, and also as of the beginning of the prior taxable year. In the case of a manufacturer, this analysis shall show in detail the manner in which costs are computed with respect to raw materials, goods in process, and finished goods, segregating the products (whether in process or finished goods) into natural groups on the basis of either (1) similarity in factory processes through which they pass, or (2) similarity of raw materials used, or (3) similarity in style, shape, or use of finished products. Each group of products shall be clearly described.

(b) The taxpayer shall submit for the consideration of the Commissioner in connection with the taxpayer's adoption or use of the LIFO inventory method such other detailed information with respect to his business or accounting system as may be at any time requested by the Commissioner.

(c) As a condition to the taxpayer's use of the LIFO inventory method, the Commissioner may require that the method be used with respect to goods other than those specified in the tax-

payer's statement of election if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income.

(d) Whether or not the taxpayer's application for the adoption and use of the LIFO inventory method should be approved, and whether or not such method, once adopted, may be continued, and the propriety of all computations incidental to the use of such method, will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns.

§ 1.472–4 Adjustments to be made by taxpayer.

A taxpayer may not change to the LIFO method of taking inventories unless, at the time he files his application for the adoption of such method, he agrees to such adjustments incident to the change to or from such method, or incident to the use of such method, in the inventories of prior taxable years or otherwise, as the district director upon the examination of the taxpayer's returns may deem necessary in order that the true income of the taxpayer will be clearly reflected for the years involved.

§ 1.472–5 Revocation of election.

An election made to adopt and use the LIFO inventory method is irrevocable, and the method once adopted shall be used in all subsequent taxable years, unless the use of another method is required by the Commissioner, or authorized by him pursuant to a written application therefor filed as provided in paragraph (e) of § 1.446–1.

§ 1.472–6 Change from LIFO inventory method.

If the taxpayer is granted permission by the Commissioner to discontinue the use of LIFO method of taking inventories, and thereafter to use some other method, or if the taxpayer is required by the Commissioner to discontinue the use of the LIFO method by reason of the taxpayer's failure to conform to the requirements detailed in § 1.472–2, the inventory of the specified goods for the first taxable year affected by the change and for each taxable year thereafter shall be taken—

(a) In conformity with the method used by the taxpayer under section 471 in inventorying goods not included in his LIFO inventory computations; or

(b) If the LIFO inventory method was used by the taxpayer with respect to all of his goods subject to inventory, then in conformity with the inventory method used by the taxpayer prior to his adoption of the LIFO inventory method; or

(c) If the taxpayer had not used inventories prior to his adoption of the LIFO inventory method and had no goods currently subject to inventory by a method other than the LIFO inventory method, then in conformity with such inventory method as may be selected by the taxpayer and approved by the Commissioner as resulting in a clear reflection of income; or

(d) In any event, in conformity with any inventory method to which the taxpayer may change pursuant to application approved by the Commissioner.

§ 1.472–7 Inventories of acquiring corporations.

For additional rules in the case of certain corporate acquisitions specified in section 381(a), see section 381(c)(5) and the regulations thereunder.

ADJUSTMENTS

§ 1.481 Statutory provisions; adjustments required by changes in method of accounting.

SEC. 481. *Adjustments required by changes in method of accounting*—(a) *General rule.* In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")—

(1) If such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then

(2) There shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

(b) *Limitation on tax where adjustments are substantial*—(1) *Three year allocation.* If—

(A) The method of accounting from which the change is made was used by the taxpayer in computing his taxable income for the 2 taxable years preceding the year of the change, and

(B) The increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a)(2), other than the amount of such adjustments to which paragraph (4) or (5) applies, exceeds $3,000,

then the tax under this chapter attributable to such increase in taxable income shall not be greater than the aggregate increase in the taxes under this chapter (or under the corresponding provisions of prior revenue laws) which would result if one-third of such increase in taxable income were included in taxable income for the year of the change and one-third of such increase were included for each of the 2 preceding taxable years.

(2) *Allocation under new method of accounting.* If—

(A) The increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a)(2), other than the amount of such adjustments to which paragraph (4) or (5) applies, exceeds $3,000, and

(B) The taxpayer establishes his taxable income (under the new method of accounting) for one or more taxable years consecutively preceding the taxable year of the change for which the taxpayer in computing taxable income used the method of accounting from which the change is made,

then the tax under this chapter attributable to such increase in taxable income shall not be greater than the net increase in the taxes under this chapter (or under the corresponding provisions of prior revenue laws) which would result if the adjustments required by subsection (a)(2), other than the amount of such adjustments to which paragraph (4) or (5) applies, were allocated to the taxable year or years specified in subparagraph (B) to which they are properly allocable under the new method of accounting and the balance of the adjustments required by subsection (a)(2), other than the amount of such adjustments to which paragraph (4) or (5) applies, was allocated to the taxable year of the change.

(3) *Special rules for computations under paragraphs (1) and (2).* For purposes of this subsection—

(A) There shall be taken into account the increase or decrease in tax for any taxable year preceding the year of the change to which no adjustment is allocated under paragraph (1) or (2) but which is affected by a net operating loss (as defined in section 172) or by a capital loss carryover (as defined in section 1212), determined with reference to taxable years with respect to which adjustments under paragraph (1) or (2) are allocated.

(B) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning of section 1314(a)) for such year.

(C) In applying section 7807(b)(1), the provisions of chapter 1 (other than subchapter E, relating to self-employment income) and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(4) *Special rule for pre-1954 adjustments generally.* Except as provided in paragraphs (5) and (6)—

(A) *Amount of adjustments to which paragraph applies.* The net amount of the adjustments required by subsection (a), to the extent that such amount does not exceed the net amount of adjustments which would have been required if the change in method of accounting had been made in the first taxable year beginning after December 31, 1953, and ending after August 16, 1954, shall be taken into account by the taxpayer in computing taxable income in the manner provided in subparagraph (B), but only if such net amount of such adjustment would increase the taxable income of such taxpayer by more than $3,000.

(B) *Years in which amounts are to be taken into account.* One-tenth of the net amount of the adjustments described in subparagraph (A) shall (except as provided in subparagraph (C)) be taken into account in each of the 10 taxable years beginning with the year of the change. The amount to be taken into account for each taxable year in the 10-year period shall be taken into account whether or not for such year the assessment of tax is prevented by operation of any law or rule of law. If the year of the change was a taxable year ending before January 1, 1958, and if the taxpayer so elects (at such time and in such manner as the Secretary or his delegate shall by regulations prescribe), the 10-year period shall begin with the first taxable year which begins after December 31, 1957. If the taxpayer elects under the preceding sentence to begin the 10-year period with the first taxable year which begins after December 31, 1957, the 10-year period shall be reduced by the number of years, beginning with the year of the change, in respect of which assessment of tax is prevented by operation of any law or rule of law on the date of the enactment of the Technical Amendments Act of 1958.

(C) *Limitation on years in which adjustments can be taken into account.* The net amount of any adjustments described in subparagraph (A), to the extent not taken into account in prior taxable years under subparagraph (B)—

(i) In the case of a taxpayer who is an individual, shall be taken into account in the taxable year in which he dies or ceases to engage in a trade or business,

(ii) In the case of a taxpayer who is a partner, his distributive share of such net amount shall be taken into account in the taxable year in which the partnership terminates, or in which the entire interest of such partner is transferred or liquidated, or

(iii) In the case of a taxpayer who is a corporation, shall be taken into account in the taxable year in which such corporation ceases to engage in a trade or business unless such net amount of such adjustment is required to be taken into account by the acquiring corporation under section 381(c)(21).

(D) *Termination of application of paragraph.* The provisions of this paragraph shall not apply with respect to changes in methods of accounting made in taxable years beginning after December 31, 1963.

(5) *Special rule for pre-1954 adjustments in case of certain decedents.* A change from the cash receipts and disbursements method to the accrual method in any case involving the use of inventories, made on or after August 16, 1954, and before January 1, 1958, for a taxable year to which this section applies, by the executor or administrator of a decedent's estate in the first return filed by such executor or administrator on behalf of the decedent, shall be given effect in determining taxable income (other than for the purpose of computing a net operating loss carryback to any prior taxable year of the decedent), and, if the net amount of any adjustments required by subsection (a) in respect of taxable years to which this section does not apply would increase the taxable income of the decedent by more than $3,000, then the tax attributable to such net adjustments shall not exceed an amount equal to the tax that would have been payable on the cash receipts and disbursements method for the years for which the executor or administrator filed returns on behalf of the decedent, computed for each such year as though a ratable portion of the taxable income for such year had been received in each of 10 taxable years beginning and ending on the same dates as the taxable year for which the tax is being computed.

(6) *Application of paragraph (4).* Paragraph (4) shall not apply with respect to any taxpayer, if the taxpayer elects to take the net amount of the adjustments described in paragraph (4)(A) into account in the manner provided by paragraph (1) or (2). An election to take the net amount of such adjustments into account in the manner provided by paragraph (1) or (2) may be made only if the taxpayer consents in writing to the assessment, within such period as may be agreed on with the Secretary or his delegate, of any deficiency for the year of the change, to the extent attributable to taking the net amount of the adjustments described in paragraph (4)(A) into account in the manner provided by paragraph (1) or (2), even though at the time of filing such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law. An election under this paragraph shall be made at such time and in such manner as the Secretary or his delegate shall by regulations prescribe.

(c) *Adjustments under regulations.* In the case of any change described in subsection (a), the taxpayer may, in such manner and subject to such conditions as the Secretary or his delegate may by regulations prescribe, take the adjustments required by subsection (a)(2) into account in computing the tax imposed by this chapter for the taxable year or years permitted under such regulations.

(d) *Exception for change to installment basis.* This section shall not apply to a change to which section 453 (relating to change to installment method) applies.

[Sec. 481 as amended by sec. 29, Technical Amendments Act 1958 (72 Stat. 1626)]

§ 1.481–1 Adjustments in general.

(a)(1) Section 481 prescribes the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a method of accounting different from that under which the taxable income was previously computed. A change in method of accounting to which section 481 applies includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. For rules relating to changes in methods of accounting, see section 446(e) and paragraph (e) of § 1.446–1. In computing taxable income for the taxable year of the change, there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent amounts from being duplicated or omitted. The "year of the change" is the taxable year for which the taxable income of the taxpayer is computed under a method of accounting different from that used for the preceding taxable year.

(2) Unless the adjustments are attributable to a change in method of accounting initiated by the taxpayer, no part of the adjustments required by subparagraph (1) of this paragraph shall be based on amounts which were taken into account in computing income (or which should have been taken into account had the new method of accounting been used) for taxable years beginning before January 1, 1954, or ending before August 17, 1954.

(b) The adjustments specified in section 481(a) and this section shall take into account inventories, accounts receivable, accounts payable, and any other item determined to be necessary in order to prevent amounts from being duplicated or omitted.

(c)(1) The term "adjustments", as used in section 481, has reference to the net amount of the adjustments required by section 481(a) and paragraph (b) of this section. In the case of a change in the over-all method of accounting, such as from the cash receipts and disbursements method to an accrual method, the term "net amount of the adjustments" means the consolidation of adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in various accounts, such as inventory, accounts receivable, and accounts payable, at the beginning of the taxable year of the change in method of accounting. With respect to the portion of the adjustments attributable to pre-1954 Code years, it is immaterial that the same items or class of items with respect to which adjustments would have to be made (for the first taxable year to which section 481 applies) do not exist at the time the actual change in method of accounting occurs. For purposes of section 481, only the net dollar balance is to be taken into account. In the case of a change in the treatment of a single material item, the amount of the adjustment shall be determined with reference only to the net dollar balances in that particular account.

(2)(i) If the change in method of accounting is voluntary (that is, initiated by the taxpayer), the entire amount of the adjustments required by section 481(a) is to be taken into account in computing taxable income for the taxable year of the change, except as otherwise provided by section 481(b)(4) and (5). However, in such a case, if the portion of the adjustments which is attributable to taxable years subject to the Internal Revenue Code of 1954 increases taxable income by more than $3,000, the limitations on tax provided in section 481(b)(1) or (2) apply.

(ii) The portion of the adjustments arising from a voluntary change in method of accounting and attributable to taxable years not subject to the 1954 Code is determined in accordance with section 481(b)(4)(A) and paragraph (a) of § 1.481–4. If such portion increases taxable income by more than $3,000 for the first taxable year to which section 481 applies, such portion may be taken into account over the period prescribed in section 481(b)(4)(B). If the total increase in taxable income arising from the adjustments required by section 481(a) is more than $3,000 for the taxable year of the change, but the portion of such adjustments attributable to pre-1954 Code years under section 481(b)(4)(A) increases taxable income by $3,000 or less for the first taxable year to which section 481 applies, then the limitations provided in section 481(b)(1) or (2) apply to the total adjustments. On the other hand, if the portion of such adjustments attributable to pre-1954 Code years increases taxable income by more than $3,000 for the first taxable year to which section 481 applies, and the portion attributable to 1954 Code years increases taxable income by $3,000 or less for the taxable year of the change, then the portion of the adjustments attributable to pre-1954 Code years may be taken into account over the period prescribed in section 481(b)(4)(B), and the portion of the adjustments attributable to 1954 Code years is to be taken into account in the taxable year of the change.

(3) If the change in method of accounting is not voluntary (that is, not initiated by the taxpayer), then only the adjustments required by section 481(a) which are attributable to taxable years subject to the Internal Revenue Code of 1954 are taken into account in computing taxable income for the taxable year of the change. If the amount of such adjustments increases taxable income by more than $3,000 for the taxable year of the change, the limitations on tax provided in section 481(b)(1) or (2) apply.

(4) If the adjustments required by section 481(a) as a result of a change in method of accounting decrease taxable income for the taxable year of the change, such decrease is taken into account for that year and the provisions of section 481(b) do not apply. In the case of an involuntary change in method of accounting, no adjustments attributable to pre-1954 Code years are taken into account, whether or not such adjustments would decrease taxable income.

(5) A change in the method of accounting initiated by the taxpayer includes not only a change which he originates by securing the consent of the Commissioner, but also a change from one method of accounting to another

made without the advance approval of the Commissioner. A change in the taxpayer's method of accounting required as a result of an examination of the taxpayer's income tax return will not be considered as initiated by the taxpayer. On the other hand, a taxpayer who, on his own initiative, changes his method of accounting in order to conform to the requirements of any Federal income tax regulation or ruling shall not, merely because of such fact, be considered to have made an involuntary change.

(6) Where the total adjustments required by section 481(a) include both—

(i) An amount attributable to 1954 Code years to which the limitations on tax provided by section 481(b) (1) or (2) apply, and

(ii) An amount attributable to pre-1954 Code years of which all or a pro rata portion thereof is to be taken into account under section 481(b)(4) (A) or (B),

two separate computations of tax must be made for the taxable year of the change. The tax for such year must first be computed under section 481(b) (1) or (2) in respect of the portion of the adjustments attributable to 1954 Code years, without regard to amounts taken into account under section 481(b)(4) (A) or (B). Then the tax for such year must be computed in respect of the portion of the adjustments attributable to pre-1954 Code years, taking into account the portion of the adjustments attributable to 1954 Code years. The total tax for the taxable year of the change will be the aggregate of the tax computed under section 481(b) (1) or (2) and the increase in tax attributable to taking into account the portion of the adjustments attributable to pre-1954 Code years under section 481(b)(4) (A) or (B).

(7) For rules relating to the limitations on tax provided by section 481(b) (1) and (2), see § 1.481–2. For rules relating to the adjustments attributable to taxable years beginning before January 1, 1954, or ending before August 17, 1954, see §§ 1.481–3 and 1.481–4.

(d) In determining the amount of any item of gain, loss, deduction, or credit which depends upon gross income, adjusted gross income, or taxable income for the taxable year of the change, the full amount of the adjustments required under section 481(a) shall be taken into account for such year if such adjustments increase taxable income by $3,000 or less, or decrease taxable income. However, if the amount of the adjustments increase taxable income by more than $3,000, the provisions of section 481 (b) apply. Since section 481 (b) (1) and (2) merely provide for limitations on the tax for the taxable year of the change, the entire amount of the adjustments which is subject to section 481(b) (1) and (2) is taken into account in such year. See § 1.481–2. Where section 481(b)(4) applies and the taxpayer does not elect to have the 10-year period begin with the first taxable year beginning after December 31, 1957, the pro rata portion of the adjustments attributable to pre-1954 Code years is also taken into account in the taxable year of the change. See § 1.481–4.

(e) The provisions of section 481 shall not apply in the case of a change from an accrual method to the installment method of accounting. In such case the rules provided in section 453 shall apply. However, section 481 does apply in the case of a change from the installment method of accounting to any other method.

§ 1.481–2 Limitation on tax.

(a) *Three-year allocation.* Section 481(b)(1) provides a limitation on the tax for the taxable year of the change attributable to the adjustments required under section 481(a) and § 1.481–1 (other than the amount of adjustments to which section 481(b) (4) or (5) applies). If such adjustments increase the taxpayer's taxable income for the taxable year of the change by more than $3,000, then the tax for such taxable year under chapter 1 of the Internal Revenue Code of 1954 attributable to the adjustments shall not exceed the lesser of (1) the tax attributable to taking such adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and § 1.481–1, or (2) the aggregate of the increases in tax under chapter 1 (or under corresponding provisions of prior revenue laws) which would result if the adjustments were included ratably in the taxable year of the change and the two preceding taxable years. For the purpose of computing the limitation on tax under section 481(b) (1), the adjustments shall be allocated ratably to the taxable year of the change and the two preceding taxable years, whether or not the adjustments are in fact attributable in whole or in part to such years. The limitation on the tax provided in this paragraph shall be applicable only if the taxpayer used the method of accounting from which the change was made in computing taxable income for the two taxable years preceding the taxable year of the change.

(b) *Allocation under new method of accounting.* Section 481(b)(2) provides a second alternative limitation on the tax for the taxable year of the change under chapter 1 attributable to the adjustments required under section 481(a) and § 1.481–1 which are not subject to section 481(b) (4) or (5) where such adjustments increase taxable income for the taxable year of the change by more than $3,000. If the taxpayer establishes from his books of account and other records what his taxable income would have been under the new method of accounting for one or more consecutive taxable years immediately preceding the taxable year of the change, and if the taxpayer in computing taxable income for such years used the method of accounting from which the change was made, then the tax attributable to the adjustments shall not exceed the smallest of the following amounts:

(1) The tax attributable to taking the adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and § 1.481–1;

(2) The tax attributable to such adjustments computed under the 3-year allocation provided in section 481(b)(1), if applicable; or

(3) The net increase in the taxes under chapter 1 (or under corresponding provisions of prior revenue laws) which would result from allocating that portion of the adjustments to the one or more consecutive preceding taxable years to which properly allocable under the new method of accounting and from allocating the balance thereof to the taxable year of the change.

(c) *Rules for computation of tax.* (1) The first step in determining whether either of the limitations described in section 481(b) (1) or (2) applies is to compute the increase in tax for the taxable year of the change which is attributable to the increase in taxable income for such year resulting solely from the adjustments required under section 481(a) and § 1.481–1 which are not subject to section 481(b) (4) or (5). This increase in tax is the excess of the tax for the taxable year computed by taking into account such adjustments under section 481(a) over the tax computed for such year without taking the adjustments into account.

(2) The next step is to compute under section 481(b)(1) the tax attributable to the adjustments referred to in subparagraph (1) of this paragraph for the taxable year of the change and the two preceding taxable years as if an amount equal to one-third of the net amount of such adjustments had been received or accrued in each of such taxable years. The increase in tax attributable to the adjustments for each such taxable year is the excess of the tax for such year computed with the allocation of one-third of the net adjustments to such taxable year over the tax computed without the allocation of any part of the adjustments to such year. For the purpose of computing the aggregate increase in taxes for such taxable years, there shall be taken into account the increase or decrease in tax for any taxable year preceding the taxable year of the change to which no adjustment is allocated under section 481(b)(1) but which is affected by a net operating loss under section 172 or by a capital loss carryover under section 1212, determined with reference to taxable years with respect to which adjustments under section 481(b)(1) are allocated.

(3) In the event that the taxpayer satisfies the conditions set forth in section 481(b)(2), the next step is to determine the amount of the net increase in tax attributable to the adjustments referred to in subparagraph (1) of this paragraph for:

(i) The taxable year of the change,

(ii) The consecutive taxable year or years immediately preceding the taxable year of the change for which the taxpayer can establish his taxable income under the new method of accounting, and

(iii) Any taxable year preceding the taxable year of the change to which no adjustment is allocated under section 481(b)(2), but which is affected by a net operating loss or by a capital loss carryover determined with reference to taxable years with respect to which such adjustments are allocated.

The net increase in tax for the taxable years specified in subdivisions (i), (ii), and (iii) of this subparagraph shall be computed as if the amount of the adjustments for the prior taxable years to which properly allocable in accordance with section 481(b)(2) had been received or accrued, or paid or incurred, as the case may be, in such prior years and the balance of the adjustments in the taxable year of the change. The amount of tax attributable to such adjustments for the taxable years specified in subdivisions (i), (ii), and (iii) of this subparagraph is the aggregate of the differences (increases and decreases) between the tax for each such year computed by taking into account the allocable portion of the adjustments in computing taxable income and the tax computed without taking into account any portion of the adjustments in computing taxable income. Generally, where there is an increase in taxable income for a preceding consecutive taxable year established under the new method of accounting, computed without regard to adjustments attributable to any preceding taxable year, the amount of the adjustments to be allocated to each such year shall be an amount equal to such increase. However, where the amount of the adjustments to be allocated to a prior taxable year is less than the increase in taxable income for such year established under the new method of accounting, the amount of the increase in such taxable income for purposes of determining the increase in tax under section 481(b)(2) for such year shall be considered to be the amount so allocated. For example, if the amount of the adjustments required by section 481(a) for 1958 (the taxable year of the change) is $60,000, and the increase in taxable income is determined by the taxpayer to be $40,000, $5,000, and $35,000, computed under the new method of accounting, for the taxable years 1957, 1956, and 1955, respectively, then the amount of the adjustments to be allocated to 1955 will be the balance of the adjustments, or $15,000.

(4) The tax for the taxable year of the change (determined without regard to adjustments under section 481(b)(4) or (5)) shall be the tax for such year, computed without taking any of the adjustments referred to in subparagraph (1) of this paragraph into account, increased by the smallest of the following amounts:

(i) The amount of tax for the taxable year of the change attributable solely to taking into account the entire amount of the adjustments required by section 481(a) and § 1.481-1 which are not subject to section 481(b)(4) or (5);

(ii) The sum of the increases in tax liability for the taxable year of the change and the two immediately preceding taxable years which would have resulted solely from taking into account one-third of the amount of such adjustments required for each of such years as though such amounts had been properly attributable to such years (computed in accordance with subparagraph (2) of this paragraph); or

(iii) The net increase in tax attributable to allocating such adjustments under the new method of accounting (computed in accordance with subparagraph (3) of this paragraph).

(5) In the case of a change in method of accounting by a partnership, the adjustments required by section 481 shall be made with respect to the taxable income of the partnership but the limitations on tax under section 481(b) shall apply to the individual partners. Each partner shall take into account his distributive share of the partnership items, as so adjusted, for the taxable year of the change. Section 481(b) applies to a partner whose taxable income is so increased by more than $3,000 as a result of such adjustments to the partnership taxable income. It is not necessary for the partner to have been a member of the partnership for the two taxable years immediately preceding the taxable year of the change of the partnership's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a partner may apply section 481(b)(2) for the purpose of limiting the increase in the partner's tax attributable to the increase in the taxable income of the partnership.

(6) For the purpose of the successive computations of the limitations on tax under section 481(b)(1) or (2), if the treatment of any item under the provisions of the Internal Revenue Code of 1954 (or corresponding provisions of prior internal revenue laws) depends upon the amount of gross income, adjusted gross income, or taxable income (for example, medical expenses, charitable contributions, or credits against the tax), such item shall be determined for the purpose of each such computation by taking into account the proper portion of the amount of any adjustments required to be taken into account under section 481 in each such computation.

(7) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning section 1314(a)) for such year.

(8) In applying section 7807(b)(1), the provisions of chapter 1 (other than subchapter E, relating to tax on self-employment income) and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(d) *Examples.* The application of section 481(b)(1) and (2) may be illustrated by the following examples. Although the examples in this paragraph are based upon adjustments required in the case of a change in the over-all method of accounting, the principles illustrated would be equally applicable to adjustments required in the case of a change in method of accounting for a particular material item, provided the treatment of such adjustments is not specifically subject to some other provision of the Internal Revenue Code of 1954.

Example (1). An unmarried individual taxpayer using the cash receipts and disbursements method of accounting for the calendar year is required by the Commissioner to change to an accrual method effective with the year 1958. As of January 1, 1958, he had an opening inventory of $11,000. On December 31, 1958, he had a closing inventory of $12,500. Merchandise purchases during the year amounted to $22,500, and net sales were $32,000. Total deductible business expenses were $5,000. There were no receivables or payables at January 1, 1958. The computation of taxable income for 1958, assuming no other adjustments, using the new method of accounting follows:

Net sales		$32,000
Opening inventory	$11,000	
Purchases	22,500	
Total	33,500	
Less closing inventory	12,500	
Cost of goods sold		21,000
Gross profit		11,000
Business expenses		5,000
Business income		6,000
Personal exemption and itemized deductions		1,600
Taxable income		4,400

Under the cash receipts and disbursements method of accounting, only $9,000 of the $11,000 opening inventory had been included in the cost of goods sold and claimed as a deduction for the taxable years 1954 through 1957; the remaining $2,000 had been so accounted for in pre-1954 Code years. In order to prevent the same item from reducing taxable income twice, an adjustment of $9,000 must be made to the taxable income of 1958 under the provisions of section 481(a) and § 1.481-1. Since the change in method of accounting was not initiated by the taxpayer, the $2,000 of opening inventory which had been included in cost of goods sold in pre-1954 Code years is not taken into account. Taxable income for 1958 is accordingly increased by $9,000 under section 481(a) to $13,400. Assuming that the tax on $13,400 is $4,002 and that the tax on $4,400 (income without the adjustment) is $944, the increase in tax attributable to the adjustment, if taken into account for the taxable year of the change, would be the difference between the two, or $3,058. Since the adjustment required by section 481(a) and § 1.481-1 ($9,000) increases taxable income by more than $3,000, the increase in tax for the taxable year 1958 attributable to the adjustment of $9,000 (i. e., $3,058) may be limited under the provisions of section 481(b)(1) or (2). See examples (2) and (3).

Example (2). Assume that the taxpayer in example (1) used the cash receipts and disbursements method of accounting in computing taxable income for the years 1956 and 1957 and that the taxable income for these years determined under such method was

$4,000 and $6,000, respectively. The section 481(b)(1) limitation on tax with a pro rata three-year allocation of the $9,000 adjustment is computed as follows:

Taxable year	Taxable income before adjustment	Taxable income with adjustment	Assumed total tax	Assumed tax before adjustment	Increase in tax attributable to adjustment
1956	$4,000	$7,000	$1,660	$840	$820
1957	6,000	9,000	2,300	1,360	940
1958	4,400	7,400	1,780	944	836
Total					2,596

Since this increase in tax of $2,596 is less than the increase in tax attributable to the inclusion of the entire adjustment in the income for the taxable year of the change ($3,058), the limitation provided by section 481(b)(1) applies, and the total tax for 1958, the taxable year of the change, if section 481(b)(2) does not apply, is determined as follows:

Tax without any portion of adjustment	$944
Increase in tax attributable to adjustment computed under section 481 (b)(1)	2,596
Total tax for taxable year of the change	3,540

Example (3). (i) Assume the same facts as in example (1) and, in addition, assume that the taxpayer used the cash receipts and disbursements method of accounting in computing taxable income for the years 1953 through 1957; that he established his taxable income under the new method for the taxable years 1953, 1954, and 1957, but did not have sufficient records to establish his taxable income under such method for the taxable years 1955 and 1956. The original taxable income and taxable income as redetermined are as follows:

Taxable year	Taxable income: Determined under cash receipts and disbursements method	Taxable income: Established under new method	Increase or (decrease) in taxable income
1953	$5,000	$7,000	$2,000
1954	6,000	7,000	1,000
1955	5,500	(1)	
1956	4,000	(1)	
1957	6,000	10,000	4,000

[1] Undetermined.

As in examples (1) and (2), the total adjustment under section 481(a) is $9,000. Of the $9,000 adjustment, $4,000 may be allocated to 1957, which is the only year consecutively preceding the taxable year of the change for which the taxpayer was able to establish his income under the new method. Since the income cannot be established under the new method for 1956 and 1955, no allocation may be made to 1954 or 1953, even though the taxpayer has established his income for those years under the new method of accounting. The balance of $5,000 ($9,000 minus $4,000) must be allocated to 1958.

(ii) The limitation provided by section 481(b)(2) is computed as follows: The tax for 1957, based on taxable income of $6,000, is assumed to be $1,360. Under the new method, based on taxable income of $10,000, the tax for 1957 is assumed to be $2,640, the increase attributable to $4,000 of the $9,000 section 481(a) adjustment being $1,280, ($2,640 minus $1,360). The tax for 1958, computed on the basis of taxable income of $4,400 (determined under the new method), is assumed to be $944. The tax computed for 1958 on taxable income of $9,400 ($4,400 plus the $5,000 adjustment allocated to 1958) is assumed to be $2,436, leaving a difference of $1,492 ($2,436 minus $944) attributable to the inclusion in 1958 of the portion of the total adjustment to be taken into account which could not be properly allocated to the taxable year or years consecutively preceding 1958.

(iii) The tax attributable to the adjustment is determined by selecting the smallest of the three following amounts:

Increase in tax attributable to adjustment computed under section 481 (b)(2) ($1,280+$1,492)	$2,772
Increase in tax attributable to adjustment computed under section 481 (b)(1) (example (2))	2,596
Increase in tax if the entire adjustment is taken into account in the taxable year of the change (example (1))	3,058

The final tax for 1958 is then $3,540 computed as follows:

Tax before inclusion of any adjustment	$944
Increase in tax attributable to adjustments (smallest of $2,772, $2,596 or $3,058)	2,596
Total tax for 1958 (limited in accordance with section 481 (b)(1))	3,540

Example (4). Assume that X Corporation has maintained its books of account and filed its income tax returns using the cash receipts and disbursements method of accounting for the years 1953 through 1957. The corporation secures permission to change to an accrual method of accounting for the calendar year 1958. The following tabulation presents the data with respect to the taxpayer's income for the years involved:

Year	Taxable income under the cash receipts and disbursements method: Before application of net operating loss carryback	Taxable income under the cash receipts and disbursements method: After application of net operating loss carryback	Taxable income established under accrual method	Increase or (decrease) attributable to change	Changes in taxable income due to changes in net operating loss carryback
1953	$2,000	0	(1)		$2,000
1954	4,000	$1,000	(1)		3,000
1955	(5,000)				
1956	80,000	80,000	$1,000	$6,000	
1957	90,000	90,000	77,000	(3,000)	
1958			96,000	6,000	
			100,000		

[1] Not established.

As indicated above, taxable income for 1953 and 1954, as determined under the cash receipts and disbursements method of accounting, was $2,000 and $4,000, respectively, and after application of the net operating loss carryback from 1955, the taxable income was reduced to zero in 1953 and to $1,000 in 1954. The taxpayer was unable to establish taxable income for these years under an accrual method of accounting; however, under section 481(b)(3)(A), increases or decreases in the tax for taxable years to which no adjustment is allocated must, nevertheless, be taken into account to the extent the tax for such years would be affected by a net operating loss determined with reference to taxable years to which adjustments are allocated. The total amount of the adjustments required under section 481(a) and attributable to the taxable years 1953 through 1957 in this example is assumed to be $10,000. The redetermination of taxable income established by the taxpayer for the taxable years 1955, 1956, and 1957 appears under the heading "Taxable income established under accrual method" in the above tabulation. The tabulation assumes that the taxpayer has been able to recompute the income for those years so as to establish a net adjustment of $9,000, which leaves a balance of $1,000 unaccounted for. In accordance with the requirements of section 481(b)(2), the $1,000 amount is allocated to 1958, the taxable year of the change. The following computations are necessary in order to determine the tax attributable to the adjustments under section 481(a):

Increase in tax attributable to inclusion in 1958 of the entire $10,000 adjustment

Tax on income of 1958 increased by entire amount of adjustment ($100,000+$10,000)	$51,700
Tax on income of 1958 without adjustment ($100,000)	46,500
Increase in tax attributable to inclusion of entire adjustment in year of the change	5,200

Year	Increase in tax attributable to adjustment computed under section 481(b)(1): Amount of adjustment	Tax before adjustment	Tax after adjustment	Increase in tax liability attributable to adjustment
1958	$3,334	$46,500	$48,234	$1,734
1957	3,333	41,300	43,033	1,733
1956	3,333	36,100	37,833	1,733
Increase in tax attributable to adjustment computed under section 481(b)(1)				$5,200

Year	Increase in tax attributable to adjustment computed under section 481(b)(2)			
	Amount of adjustment	Tax before adjustment	Tax after adjustment	Increase or (decrease) in tax liability
1953	[1] $2,000	0	[1] $600	$600
1954	[1] 3,000	$300	[1] 1,200	900
1955	6,000	0	300	300
1956	(3,000)	36,100	34,540	(1,560)
1957	6,000	41,300	44,420	3,120
1958	[2] 1,000	46,500	[2] 47,020	520
Increase in tax attributable to the adjustment computed under section 481(b)(2)				$3,880

[1] Attributable to recomputations of net operating loss carrybacks determined with reference to net operating loss in 1955.

[2] Attributable to the inclusion of $1,000 in the year of the change which represents the portion of the $10,000 adjustment not allocated to taxable years prior to the year of the change for which taxable income is established under the new method.

Since the limitation under section 481(b)(2) ($3,880) on the amount of tax attributable to the adjustments is applicable, the final tax for the taxable year of the change is computed by adding such amount to the tax for that year computed without the inclusion of any amount attributable to the adjustments, that is, $46,500 plus $3,880, or $50,380.

1.481–3 Adjustments attributable to pre-1954 Code years where change was not initiated by taxpayer.

If the adjustments required by section 481(a) and § 1.481–1 are attributable to a change in method of accounting which was not initiated by the taxpayer, no portion of any adjustments which is attributable to pre-1954 Code years shall be taken into account in computing taxable income. For example, if the total adjustments in the case of a change in method of accounting which is not initiated by the taxpayer amount to $10,000, of which $4,000 is attributable to pre-1954 Code years, only $6,000 of the $10,000 total adjustments is required to be taken into account under section 481 in computing taxable income. The portion of the adjustments which is attributable to pre-1954 Code years is the net amount of the adjustments which would have been required if the taxpayer had changed his method of accounting in his first taxable year which began after December 31, 1953, and ended after August 16, 1954. See section 481(b)(4)(A).

§ 1.481–4 Adjustments attributable to pre-1954 Code years where change was initiated by taxpayer.

(a) *Amount of adjustments to be taken into account.* If the adjustments required by section 481(a) and § 1.481–1 are attributable to a change in method of accounting initiated by the taxpayer, the amount of such adjustments, to the extent such amount does not exceed the net amount which would have been required if the change had been made in the first taxable year beginning after December 31, 1953, and ending after August 16, 1954, shall be taken into account by the taxpayer in computing taxable income in the manner provided in section 481(b)(4)(B) and paragraph (b) of this section. The preceding sentence shall apply only if such amount would increase taxable income for such year by more than $3,000. For example, if the total adjustments amount to $19,000, and the portion of the adjustments attributable to pre-1954 Code years is $10,000 and the balance of $9,000 is attributable to taxable years subject to the 1954 Code, the adjustments shall be taken into account as follows:

(1) The portion attributable to pre-1954 Code years ($10,000) shall be taken into account in the manner provided in section 481(b)(4)(B) and paragraph (b) of this section, and the limitations provided in section 481(b) (1) or (2) will apply to the balance of $9,000; or

(2) If the taxpayer elects under section 481(b)(6) to take the adjustments attributable to pre-1954 Code years into account under section 481(b) (1) or (2), the limitations provided in section 481(b) (1) or (2) will apply to the entire amount of the adjustments ($19,000).

The provisions of section 481(b)(4), section 481(b)(6), and paragraphs (b), (c), (d), and (e) of this section shall not apply with respect to changes in methods of accounting made in taxable years beginning after December 31, 1963.

(b) *Years for which amounts are to be taken into account.* (1) If the amount of the adjustments determined in accordance with section 481(b)(4)(A) and paragraph (a) of this section would increase the taxable income of the taxpayer for the first taxable year to which section 481 applies by more than $3,000, the amount of such adjustments shall, except as provided in paragraphs (c), (d), (f), and (g) of this section, be taken into account—

(i) One-tenth in each of the 10 taxable years beginning with the taxable year of the change, or

(ii) If the taxable year of the change was a taxable year beginning after December 31, 1953, and ending after August 16, 1954, but before January 1, 1958, and if the taxpayer makes the election under section 481(b)(4)(B) in the manner provided in subparagraph (4) of this paragraph, one-tenth in each of the 10 taxable years beginning with the first taxable year which begins after December 31, 1957.

(2) (i) The 10-year period which begins with the taxable year of the change shall be reduced by the number of years in respect of which assessment of the tax is prevented by operation of any law or rule of law. In the case of a taxpayer whose taxable year of the change ended before January 1, 1958, and who elects to use the period provided for in subparagraph (1)(ii) of this paragraph, the 10-year period which begins with the first taxable year beginning after December 31, 1957, shall be reduced by the number of years which corresponds to the number of taxable years, beginning with the taxable year of the change in respect of which assessment of the tax was prevented by the operation of any law or rule of law on September 2, 1958.

(ii) In the case of such a shortened period, the portion of the adjustments to be taken into account in any one taxable year within such shortened period shall be one-tenth of such adjustments, that is, the same pro rata portion which would have been taken into account in such taxable year if the 10-year period beginning with such first taxable year had not been shortened. If, for example, in a case where the 10-year period is properly used, assessment of a deficiency is prevented with respect to 1 of the 10 taxable years in which one-tenth of the adjustments would otherwise be required to be taken into account, then only nine-tenths of such adjustments is to be taken into account ratably in the other 9 taxable years. Thus, if the adjustments required under section 481(a) amount to $10,000 and assessment of a deficiency for the calendar year 1954 (the taxable year of the change) is prevented, only nine-tenths of the adjustments, or $9,000, is to be taken into account in 1955 and the eight following taxable years at the rate of $1,000 a year. Similarly, if the taxpayer elects to begin the 10-year period with the taxable year 1958, only nine-tenths, or $9,000, is to be taken into account in 1958 and the eight following taxable years at the rate of $1,000 a year.

(3) If assessment of a deficiency is prevented with respect to a taxable year for which a prorated part would otherwise be required to be taken into account under subparagraphs (1) and (2) of this paragraph, section 481(b)(4)(B) does not reopen that year for assessment purposes.

(4) The election provided in section 481(b)(4)(B) and subparagraph (1) of this paragraph shall be made—

(i) In cases where the taxpayer requests the Commissioner's permission to change his method of accounting, at the time such request is made or at such other time as the Commissioner, prior to granting the taxpayer permission to make the change, may afford the taxpayer an opportunity to make such election; or

(ii) In cases where the taxpayer changed his method of accounting without the advance approval of the Commissioner and has not made an election to return to his former method of accounting in accordance with § 1.481–6, at any time before May 21, 1959.

The election shall be in the form of a written statement to the effect that the taxpayer elects under section 481(b)(4)(B) to take the adjustments determined in accordance with section 481(b)(4)(A) into account in the 10-year period beginning with the first taxable year beginning after December 31, 1957, and that the taxpayer agrees to include one-tenth of such adjustments in taxable income for such years in the man-

ner provided in subparagraph (2) of this paragraph. In the case of a partnership, the election shall be made by the individual partners. In the case of a taxpayer referred to in subdivision (i) of this subparagraph, the statement of election shall be filed with the Commissioner of Internal Revenue Attention: T:R, Washington 25, D.C. In the case of a taxpayer referred to in subdivision (ii) of this subparagraph, the statement of election shall be filed with the district director with whom he filed his income tax return for the taxable year of the change.

(c) *Limitation on years in which adjustments can be taken into account.* The amount of any adjustments determined in accordance with section 481(b)(4)(A) and paragraph (a) of this section, to the extent not taken into account in prior taxable years under section 481(b)(4)(B) and paragraph (b) of this section, shall be taken into account as follows:

(1) In the case of an individual taxpayer, such amount shall be taken into account in the taxable year in which he dies or ceases to engage in a trade or business;

(2) In the case of a partner, his distributive share of such amount shall be taken into account in his taxable year in which the partnership terminates or in which his entire interest in such partnership is transferred or liquidated; or

(3) In the case of a corporation, such amount shall be taken into account in the taxable year in which the corporation ceases to engage in a trade or business, unless the amount is required to be taken into account by the acquiring corporation under section 381(c)(21) and the regulations thereunder.

(d) *Election under section 481(b)(6).* (1) Under section 481(b)(6) a taxpayer may elect to take the adjustments determined in accordance with section 481(b)(4)(A) and paragraph (a) of this section into account in the manner provided in section 481(b)(1) or (2) and paragraphs (a) or (b) of § 1.481–2 in lieu of taking such adjustments into account under the 10-year allocation rule provided in section 481(b)(4)(B) and paragraph (b) of this section. If a taxpayer makes the election under section 481(b)(6), such taxpayer may not take any portion of the adjustments into account under the 10-year allocation rule provided in section 481(b)(4)(B). In such cases, the entire amount of the adjustments required by section 481(a) is to be taken into account in computing taxable income for the taxable year of the change, subject to the limitations on tax provided in section 481(b)(1) or (2). For example, if the adjustments resulting from a change in method of accounting which occurred in 1956 amount to $25,000, of which $10,000 is attributable to pre-1954 Code years, and the taxpayer elects under section 481(b)(6) to take such adjustments into account in the manner provided by section 481(b)(1) or (2), the limitations on tax provided in section 481(b)(1) or (2) shall apply to the entire $25,000 adjustments.

(2) The election under section 481(b)(6) may be made only if the taxpayer consents in writing to the assessment, within such period as may be agreed upon with the Commissioner or district director, of any deficiency for the taxable year of the change in the method of accounting which results from taking such adjustments into account in the manner so elected, even though at the time of filing such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

(3) The election provided in section 481(b)(6) shall be made within the time prescribed by law for filing the return (including extensions of time therefor) for the taxable year of the change, or within 90 days after the date on which the Commissioner grants permission to the taxpayer to change his method of accounting, or at any time before May 21, whichever is later. The statement shall be filed with the district director with whom the taxpayer files his income tax return for the taxable year of the change and shall be attached to the return for such year or, in the case of returns previously filed, the statement shall be attached to the necessary amended return or returns.

(e) *Example.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). X Corporation has been filing its income tax returns and keeping its books on the cash receipts and disbursements method of accounting for the calendar year. It requests, and is granted, the permission of the Commissioner, effective with the calendar year 1960, to change to an accrual method of accounting. As of January 1, 1954, the taxpayer had an opening inventory of $20,000, accounts receivable of $22,000, and accounts payable of $14,000. As of January 1, 1960, its records reflect an opening inventory of $34,000, accounts receivable of $32,000, and accounts payable of $19,000. The corporation has no other items which require adjustment under section 481(a). The adjustments required to be made by X Corporation in 1960 under section 481(a) amount to $47,000 ($34,000 plus $32,000 less $19,000). The amount of the adjustments which X Corporation would have been required to make if it had changed its method of accounting for the calendar year 1954 is $28,000 ($20,000 plus $22,000 less $14,000). Since such $28,000 of adjustments in respect of pre-1954 Code years would increase the taxable income for 1954 by more than $3,000, and since the adjustments are attributable to a change in method of accounting initiated by the taxpayer, such $28,000 of adjustments shall be taken into account under section 481(b)(4)(B) and paragraph (b) of § 1.481–4, unless X Corporation elects under section 481(b)(6) to have the limitations on tax provided by section 481(b)(1) or (2) apply to such adjustments. The remaining portion ($19,000) of the adjustments required by section 481(a) is to be taken into account in 1960, subject, however, to the tax limitation applicable under the 3-year allocation method of section 481(b)(1) or the new-accounting-method allocation under section 481(b)(2).

Example (2). If the facts in example (1) were the same except that as of January 1, 1960, the three adjustments are such that only $20,000 of adjustments is required to be taken into account under section 481(a) for 1960, then the entire amount of adjustments ($20,000) is to be taken into account in the manner provided by section 481(b)(4) or section 481(b)(6) since such amount does not exceed the $28,000 of adjustments that would have been required if the taxpayer had changed its method of accounting for the calendar year 1954.

(f) *Special rule for pre-1954 adjustments in case of certain decedents.* Section 481(b)(5) provides a special rule in respect of the tax attributable to pre-1954 adjustments in the case of a change from the cash receipts and disbursements method to an accrual method involving the use of inventories made on or after August 16, 1954, and before January 1, 1958, for a taxable year to which section 481 applies, by the executor or administrator of a decedent's estate in the first income tax return filed by such executor or administrator on behalf of the decedent. Such rule provides that—

(1) Such a change shall be given effect in determining taxable income (other than for the purpose of computing a net operating loss carryback to any prior taxable year of the decedent); and

(2) If the adjustments required by section 481(a) in respect of taxable years to which section 481 does not apply would increase taxable income of the decedent by more than $3,000, then the tax attributable to such adjustments shall not exceed an amount equal to the tax that would have been payable on the cash receipts and disbursements method for the years for which the executor or administrator filed income tax returns on behalf of the decedent, computed for each such year as though a ratable portion of the taxable income for such year had been received in each of 10 taxable years beginning and ending on the same dates as the taxable year for which the tax is being computed.

(g) *Exception for certain agreements.* (1) Section 29(d)(2) of the Technical Amendments Act of 1958 (72 Stat. 1629) provides as follows:

Sec. 29. Adjustments required by changes in method of accounting. * * *

(d) *Effective date.* * * *

(2) *Exception for certain agreements.* The amendments made by subsections (a), (b)(1), and (c) shall not apply if before the date of the enactment of this Act—

(A) The taxpayer applied for a change in the method of accounting in the manner provided by regulations prescribed by the Secretary of the Treasury or his delegate, and

(B) The taxpayer and the Secretary of the Treasury or his delegate agreed to the terms and conditions for making the change.

(2) The amendments made to section 481 by section 29 (other than paragraphs 2 through 5 of subsection (b)) of the Technical Amendments Act of 1958 shall not apply if, before September 2, 1958, the taxpayer applied for a change in method of accounting in the manner provided by any Federal income tax regulation and the taxpayer and the Commissioner agreed to the terms and conditions for making the change.

(3) A taxpayer who, in accordance with any provision of the Code or of any Federal income tax regulation permitting such action, elected to change his method of accounting with regard to one or more material items, such as research and experimental expenditures (section 174), soil and water conservation expenditures (section 175), last-in, first-out inventories (section 472), and exploration expenditures (section 615),

and who satisfied the requirements of the regulations dealing with such elections, shall be treated for purposes of section 29(d)(2) of the Technical Amendments Act of 1958 as a taxpayer who applied for and changed his method of accounting in the manner provided by regulations and who agreed to the terms and conditions for making the change.

§ 1.481–5 Adjustments taken into account with consent.

(a) In addition to the methods of allocation described in section 481(b), the adjustments required by section 481(a) may be taken into account in computing the tax under chapter 1 of the Code for such taxable years, in such manner and subject to such conditions as may be agreed upon between the Commissioner and the taxpayer. See section 481(c). Requests for approval of a method of allocation differing from those described in section 481(b) shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington 25, D.C., and shall set forth in detail the facts and circumstances upon which the taxpayer bases his request. Permission will be granted only if the taxpayer and the Commissioner agree to the terms and conditions under which the allocation is to be effected.

(b) The agreement shall be in writing and shall be signed by the Commissioner and the taxpayer. It shall set forth the items to be adjusted, the amount of the adjustments, the taxable year or years for which the adjustments are to be taken into account, and the amount of the adjustments allocable to each such year. The agreement shall be binding on the parties except upon a showing of fraud, malfeasance, or misrepresentation of a material fact.

§ 1.481–6 Election to return to former method of accounting.

(a) Section 29(e) of the Technical Amendments Act of 1958 (72 Stat. 1629) provides as follows:

Sec. 29. Adjustments required by changes in method of accounting. * * *

(e) *Election to return to former method of accounting*—(1) *Election.* Any taxpayer who for any taxable year beginning after December 31, 1953, and ending after August 16, 1954, and before the date of enactment of this Act, computed his taxable income under a method of accounting different from the method under which his taxable income for the preceding taxable year was computed, may elect to recompute his taxable income, beginning with the taxable year for which taxable income was computed under such different method of accounting, under the method of accounting under which taxable income was computed for such preceding taxable year. An election under this paragraph shall be made within 6 months after the date of the enactment of this Act, and shall be made in such manner as the Secretary of the Treasury or his delegate may provide. This paragraph shall not apply to any taxpayer—

(A) To whom subsection (d)(2) applies, or

(B) Who was required, before the date of the enactment of this Act, by the Secretary of the Treasury or his delegate to change his method of accounting.

(2) *Statute of limitations.* If assessment of any deficiency for any taxable year resulting from an election under paragraph (1) is prevented on the date on which such election is made, or at any time within one year after such date, by the operation of any law or rule of law, such assessment may, nevertheless, be made if made within one year after such date. An election by a taxpayer under paragraph (1) shall be considered as a consent to the assessment pursuant to this paragraph of any such deficiency. If refund or credit of any overpayment of income tax resulting from an election under paragraph (1) is prevented on the date on which such election is made, or at any time within one year after such date, by the operation of any law or rule of law, refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within one year after such date.

(b) Except as provided in paragraph (e) of this section, a taxpayer who for any taxable year beginning after December 31, 1953, and ending after August 16, 1954, but before September 2, 1958, computed his taxable income under a method of accounting different from the method used for the immediately preceding taxable year may elect to recompute his taxable income, beginning with the taxable year for which such method was first used, under the method used for such preceding taxable year.

(c) The election referred to in paragraph (b) of this section shall be made in the following manner:

(1) On or before March 2, 1959, the taxpayer shall file with the district director with whom he filed his income tax return for the taxable year of the change a statement to the effect that he elects to recompute his taxable income, beginning with the first taxable year for which he computed his taxable income under a method of accounting different from the preceding taxable year, under the method used for such preceding taxable year. The statement shall indicate the first taxable year for which taxable income was computed under a different method of accounting; and

(2) On or before June 1, 1959, the taxpayer shall file amended income tax returns for all taxable years affected by the election with a statement attached thereto showing the recomputation of taxable income for such taxable years under the method of accounting which he used in computing taxable income for the taxable year immediately preceding the taxable year of the change. The taxpayer shall also compute the amount of deficiency or overassessment in tax resulting from such recomputation of taxable income.

(d) (1) If assessment of a deficiency for any taxable year resulting from an election under this section is prevented on the date on which the election is made, or at any time within one year after such date, by the operation of any law or rule of law, such assessment may, nevertheless, be made within one year after such date. An election under this section shall be considered as a consent to the assessment of any such deficiency.

(2) If refund or credit of any overpayment of income tax resulting from an election under this section is prevented on the date on which such election is made, or at any time within one year after such date, by the operation of any law or rule of law, refund or credit of such overpayment may, nevertheless, be made or allowed if a claim for such refund or credit is filed within one year after such date.

(e) An election under this section may not be made by a taxpayer—

(1) To whom paragraph (g) of § 1.481–4, relating to exception for certain agreements, applies, or

(2) Who was required, before September 2, 1958, by the Commissioner or district director to change his method of accounting.

For purposes of subparagraph (2) of this paragraph, a taxpayer, who on his own initiative, changed his method of accounting in order to conform to the requirements of any Federal income tax regulation or ruling shall not, merely because of such fact, be considered to be a taxpayer who was required, for purposes of section 481, to change his method of accounting.

§ 1.482 [Reserved.]

EXEMPT ORGANIZATIONS

GENERAL RULE

§ 1.501(a) Statutory provisions; exemption from tax on corporations; certain trusts, etc.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.*—(a) *Exemption from taxation.* An organization described in subsection (c) or (d) or section 401 (a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502, 503, or 504.

§ 1.501(a)–1 Exemption from taxation.

(a) *In general; proof of exemption.* (1) Section 501(a) provides an exemption from income taxes for organizations which are described in section 501 (c) or (d) and section 401 (a), unless such organization is a "feeder organization" (see section 502), or unless it engages in a transaction described in section 503 or in an activity described in section 504. However, the exemption does not extend to "unrelated business taxable income" of such an organization (see part II (section 511 and following), subchapter F, chapter 1 of the Code).

(2) An organization, other than an employees' trust described in section 401 (a), is not exempt from tax merely because it is not organized and operated for profit. In order to establish its exemption, it is necessary that every such organization claiming exemption file an application form as set forth below with the district director for the internal revenue district in which is located the principal place of business or principal office of the organization. Subject only to the Commissioner's inherent power to revoke rulings because of a change in the law or regulations or for other good cause, an organization that has been determined by the Commissioner or the district director to be exempt under section 501(a) or the corresponding provision of prior law may rely upon such determination so long as there are no substantial changes in the organization's character, purposes, or methods of operation. An organization which has been determined to be exempt under the provisions of the Internal Revenue Code of 1939 or prior law is not required to secure a new determination of exemption merely because of the enactment of the Internal Revenue Code of

1954 unless affected by substantive changes in law made by such Code.

(3) (i) An organization claiming exemption under section 501 (a) and described in section 501 (c) (2), (3), (4), (5), (6), (7), (8), (9), (12), (13), or (15) shall file the form of application appropriate to its activities, filled out in accordance with the instructions on the form or issued therewith. The following forms shall be filed: For organizations described in section 501 (c) (3), Form 1023; in section 501 (c) (4), (5), (6), or (8), Form 1024; in section 501 (c) (7), Form 1025; and in section 501 (c) (2), (9), (12), (13), or (15), Form 1026. State chartered credit unions described in section 501 (c) (14) shall submit an application for exemption showing the State and date of incorporation. The application should show that the State credit union law with respect to loans, investments, and dividends, if any, is being complied with. All other organizations claiming exemption, other than employees' trusts described in section 401 (a), shall file an application for exemption showing the character of the organization, the purpose for which it was organized, its actual activities, the sources of its income and receipts and the disposition thereof, whether or not any of its income or receipts is credited to surplus or may inure to the benefit of any private shareholder or individual, and in general all facts relating to its operations which affect its right to exemption. To each such form or application shall be attached a conformed copy of the articles of incorporation, declaration of trust, or other instrument of similar import, setting forth the permitted powers or activities of the organization, the by-laws or other code of regulations, and the latest financial statement showing the assets, liabilities, receipts, and disbursements of the organization. Each such form or application shall contain or be verified by a written declaration that it is made under the penalties of perjury.

(ii) For the rules relating to obtaining a determination of exempt status by an employees' trust described in section 401 (a), see paragraph (e) of § 1.401–1.

(b) *Additional proof by particular classes of organizations.* (1) Organizations mentioned below shall submit with and as a part of their applications the following information:

(i) Mutual insurance companies shall submit copies of the policies or certificates of membership issued by them.

(ii) In the case of title holding companies described in section 501 (c) (2), if the organization for which title is held has not been specifically notified in writing by the Internal Revenue Service that it is held to be exempt under section 501 (a), the title holding company shall submit the information indicated herein as necessary for a determination of the status of the organization for which title is held.

(iii) An organization described in section 501(c)(3) shall submit with, and as a part of, an application filed after July 26, 1959, a detailed statement of its proposed activities.

(2) In addition to the information specifically called for by this section, the Commissioner may require any additional information deemed necessary for a proper determination of whether a particular organization is exempt under section 501 (a), and when deemed advisable in the interest of an efficient administration of the internal revenue laws, he may in the cases of particular types of organizations prescribe the form in which the proof of exemption shall be furnished.

(3) An organization claiming to be specifically exempted by section 6033 (a) from filing annual returns shall submit with and as a part of its application a statement of all the facts on which it bases its claim.

(c) *"Private shareholder or individual" defined.* The words "private shareholder or individual" in section 501 refer to persons having a personal and private interest in the activities of the organization.

(d) *Requirement of annual returns.* For the annual return requirements of organizations exempt under section 501 (a), see section 6033 and § 1.6033–1.

§ 1.501(b) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; tax on unrelated business income.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(b) *Tax on unrelated business income.* An organization exempt from taxation under subsection (a) shall be subject to tax to the extent provided in part II of this subchapter (relating to tax on unrelated income), but, notwithstanding part II, shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

§ 1.501(c)(1) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; instrumentalities of the United States.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

(1) Corporations organized under Act of Congress, if such corporations are instrumentalities of the United States and if, under such Act, as amended and supplemented, such corporations are exempt from Federal income taxes.

§ 1.501(c)(2) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; corporations organized to hold title to property for exempt organizations.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(2) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under this section.

§ 1.501(c)(2)–1 Corporations organized to hold title to property for exempt organizations.

(a) A corporation described in section 501(c)(2) and otherwise exempt from tax under section 501(a) is taxable upon its unrelated business taxable income if the income is payable to an organization which is itself subject to the tax imposed by section 511 or if the income is payable to a church or to a convention or association of churches. See part II (section 511 and following), subchapter F, chapter 1 of the Code, and the regulations thereunder. Since a corporation described in section 501(c)(2) cannot be exempt under section 501(a) if it engages in any business other than that of holding title to property and collecting income therefrom, it cannot have unrelated business taxable income as defined in section 512 other than unrelated business rental income described in section 514.

(b) A corporation described in section 501 (c) (2) cannot accumulate income and retain its exemption, but it must turn over the entire amount of such income, less expenses, to an organization which is itself exempt from tax under section 501 (a).

§ 1.501(c)(3) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

§ 1.501(c)(3)–1 Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

(a) *Organizational and operational tests.* (1) In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

(2) The term "exempt purpose or purposes", as used in this section, means any purpose or purposes specified in section 501(c)(3), as defined and elaborated in paragraph (d) of this section.

(b) *Organizational test*—(1) *In general.* (i) An organization is organized exclusively for one or more exempt purposes only if its articles of organization (referred to in this section as its

"articles") as defined in subparagraph (2) of this paragraph:

(*a*) Limit the purposes of such organization to one or more exempt purposes; and

(*b*) Do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

(ii) In meeting the organizational test, the organization's purposes, as stated in its articles, may be as broad as, or more specific than, the purposes stated in section 501(c)(3). Therefore, an organization which, by the terms of its articles, is formed "for literary and scientific purposes within the meaning of section 501(c)(3) of the Code" shall, if it otherwise meets the requirements in this paragraph, be considered to have met the organizational test. Similarly, articles stating that the organization is created solely "to receive contributions and pay them over to organizations which are described in section 501(c)(3) and exempt from taxation under section 501(a)" are sufficient for purposes of the organizational test. Moreover, it is sufficient if the articles set forth the purpose of the organization to be the operation of a school for adult education and describe in detail the manner of the operation of such school. In addition, if the articles state that the organization is formed for "charitable purposes", such articles ordinarily shall be sufficient for purposes of the organizational test (see subparagraph (5) of this paragraph for rules relating to construction of terms).

(iii) An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it to carry on, otherwise than as an insubstantial part of its activities, activities which are not in furtherance of one or more exempt purposes, even though such organization is, by the terms of such articles, created for a purpose that is no broader than the purposes specified in section 501(c)(3). Thus, an organization that is empowered by its articles "to engage in a manufacturing business", or "to engage in the operation of a social club" does not meet the organizational test regardless of the fact that its articles may state that such organization is created "for charitable purposes within the meaning of section 501(c)(3) of the Code."

(iv) In no case shall an organization be considered to be organized exclusively for one or more exempt purposes, if, by the terms of its articles, the purposes for which such organization is created are broader than the purposes specified in section 501(c)(3). The fact that the actual operations of such an organization have been exclusively in furtherance of one or more exempt purposes shall not be sufficient to permit the organization to meet the organizational test. Similarly, such an organization will not meet the organizational test as a result of statements or other evidence that the members thereof intend to operate only in furtherance of one or more exempt purposes.

(v) An organization must, in order to establish its exemption, submit a detailed statement of its proposed activities with and as a part of its application for exemption (see paragraph (b) of § 1.501(a)–1).

(2) *Articles of organization.* For purposes of this section, the term "articles of organization" or "articles" includes the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created.

(3) *Authorization of legislative or political activities.* An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it—

(i) To devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise; or

(ii) Directly or indirectly to participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office; or

(iii) To have objectives and to engage in activities which characterize it as an "action" organization as defined in paragraph (c)(3) of this section.

The terms used in subdivisions (i), (ii), and (iii) of this subparagraph shall have the meanings provided in paragraph (c)(3) of this section.

(4) *Distribution of assets on dissolution.* An organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. An organization's assets will be considered dedicated to an exempt purpose, for example, if, upon dissolution, such assets would, by reason of a provision in the organization's articles or by operation of law, be distributed for one or more exempt purposes, or to the Federal government, or to a State or local government, for a public purpose, or would be distributed by a court to another organization to be used in such manner as in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized. However, an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.

(5) *Construction of terms.* The law of the State in which an organization is created shall be controlling in construing the terms of its articles. However, any organization which contends that such terms have under State law a different meaning from their generally accepted meaning must establish such special meaning by clear and convincing reference to relevant court decisions, opinions of the State attorney-general, or other evidence of applicable State law.

(6) *Applicability of the organizational test.* A determination by the Commissioner or a district director that an organization is described in section 501(c)(3) and exempt under section 501(a) will not be granted after July 26, 1959 (regardless of when the application is filed), unless such organization meets the organizational test prescribed by this paragraph. If, before July 27, 1959, an organization has been determined by the Commissioner or district director to be exempt as an organization described in section 501(c)(3) or in a corresponding provision of prior law and such determination has not been revoked before such date, the fact that such organization does not meet the organizational test prescribed by this paragraph shall not be a basis for revoking such determination. Accordingly, an organization which has been determined to be exempt before July 27, 1959, and which does not seek a new determination of exemption is not required to amend its articles of organization to conform to the rules of this paragraph, but any organization which seeks a determination of exemption after July 26, 1959, must have articles of organization which meet the rules of this paragraph. For the rules relating to whether an organization determined to be exempt before July 27, 1959, is organized exclusively for one or more exempt purposes, see 26 CFR (1939) 39.101(6)–1 (Regulations 118) as made applicable to the Code by Treasury Decision 6091, approved August 16, 1954 (19 F.R. 5167; C.B. 1954–2, 47).

(c) *Operational test*—(1) *Primary activities.* An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

(2) *Distribution of earnings.* An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. For the definition of the words "private shareholder or individual", see paragraph (c) of § 1.501(a)–1.

(3) *"Action" organizations.* (i) An organization is not operated exclusively for one or more exempt purposes if it is an "action" organization as defined in subdivisions (ii), (iii), or (iv) of this subparagraph.

(ii) An organization is an "action" organization if a substantial part of its activities is attempting to influence legislation by propaganda or otherwise. For this purpose, an organization will be regarded as attempting to influence legislation if the organization—

(*a*) Contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or

(*b*) Advocates the adoption or rejection of legislation.

The term "legislation", as used in this subdivision, includes action by the Congress, by any State legislature, by any local council or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure. An organization will not fail to meet the operational test merely

because it advocates, as an insubstantial part of its activities, the adoption or rejection of legislation.

(iii) An organization is an "action" organization if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office. The term "candidate for public office" means an individual who offers himself, or is proposed by others, as a contestant for an elective public office, whether such office be national, State, or local. Activities which constitute participation or intervention in a political campaign on behalf of or in opposition to a candidate include, but are not limited to, the publication or distribution of written or printed statements or the making of oral statements on behalf of or in opposition to such a candidate.

(iv) An organization is an "action" organization if it has the following two characteristics: (*a*) Its main or primary objective or objectives (as distinguished from its incidental or secondary objectives) may be attained only by legislation or a defeat of proposed legislation; and (*b*) it advocates, or campaigns for, the attainment of such main or primary objective or objectives as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public. In determining whether an organization has such characteristics, all the surrounding facts and circumstances, including the articles and all activities of the organization, are to be considered.

(v) An "action" organization, described in subdivisions (ii) or (iv) of this subparagraph, though it cannot qualify under section 501(c)(3), may nevertheless qualify as a social welfare organization under section 501(c)(4) if it meets the requirements set out in paragraph (a) of § 1.501(c)(4)–1.

(d) *Exempt purposes*—(1) *In general.* (i) An organization may be exempt as an organization described in section 501(c)(3) if it is organized and operated exclusively for one or more of the following purposes:

(*a*) Religious,
(*b*) Charitable,
(*c*) Scientific,
(*d*) Testing for public safety,
(*e*) Literary,
(*f*) Educational, or
(*g*) Prevention of cruelty to children or animals.

(ii) An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

(iii) Since each of the purposes specified in subdivision (i) of this subparagraph is an exempt purpose in itself, an organization may be exempt if it is organized and operated exclusively for any one or more of such purposes. If, in fact, an organization is organized and operated exclusively for an exempt purpose or purposes, exemption will be granted to such an organization regardless of the purpose or purposes specified in its application for exemption. For example, if an organization claims exemption on the ground that it is "educational", exemption will not be denied if, in fact, it is "charitable".

(2) *Charitable defined.* The term "charitable" is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency. The fact that an organization which is organized and operated for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily prevent such organization from being exempt as an organization organized and operated exclusively for charitable purposes. The fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinion on controversial issues with the intention of molding public opinion or creating public sentiment to an acceptance of its views does not preclude such organization from qualifying under section 501(c)(3) so long as it is not an "action" organization of any one of the types described in paragraph (c)(3) of this section.

(3) *Educational defined*—(i) *In general.* The term "educational", as used in section 501(c)(3), relates to—

(*a*) The instruction or training of the individual for the purpose of improving or developing his capabilities; or

(*b*) The instruction of the public on subjects useful to the individual and beneficial to the community.

An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.

(ii) *Examples of educational organizations.* The following are examples of organizations which, if they otherwise meet the requirements of this section, are educational:

Example (*1*). An organization, such as a primary or secondary school, a college, or a professional or trade school, which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on.

Example (*2*). An organization whose activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs. Such programs may be on radio or television.

Example (*3*). An organization which presents a course of instruction by means of correspondence or through the utilization of television or radio.

Example (*4*). Museums, zoos, planetariums, symphony orchestras, and other similar organizations.

(4) *Testing for public safety defined.* The term "testing for public safety", as used in section 501(c)(3), includes the testing of consumer products, such as electrical products, to determine whether they are safe for use by the general public.

(e) *Organizations carrying on trade or business*—(1) *In general.* An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3) even though it has certain religious purposes, its property is held in common, and its profits do not inure to the benefit of individual members of the organization. See, however, section 501(d) and § 1.501(d)–1, relating to religious and apostolic organizations.

(2) *Taxation of unrelated business income.* For provisions relating to the taxation of unrelated business income of certain organizations described in section 501(c)(3), see sections 511 to 515, inclusive, and the regulations thereunder.

(3) *Prohibited transactions and accumulations.* For provisions relating to the denial of exempt status to certain organizations described in section 501(c)(3) for engaging in certain prohibited transactions or unreasonably accumulating income, see sections 503 and 504 and the regulations thereunder.

(f) *Applicability of regulations in this section.* The regulations in this section are, except as otherwise expressly provided, applicable with respect to taxable years beginning after July 26, 1959. For the rules applicable with respect to taxable years beginning before July 27, 1959, see 26 CFR (1939) 39.101(6)–1 (Regulations 118) as made applicable to the

(f) Educational, or

Code by Treasury Decision 6091, approved August 16, 1954 (19 F.R. 5167; C.B. 1954–2, 47).

§ 1.501(c)(4) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; civic organizations.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(4) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

§ 1.501(c)(4)–1 Civic organizations and local associations of employees.

(a) *Civic organizations*—(1) *In general.* A civic league or organization may be exempt as an organization described in section 501(c)(4) if—

(i) It is not organized or operated for profit; and

(ii) It is operated exclusively for the promotion of social welfare.

(2) *Promotion of social welfare*—(i) *In general.* An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements. A "social welfare" organization will qualify for exemption as a charitable organization if it falls within the definition of "charitable" set forth in paragraph (d)(2) of § 1.501(c)(3)–1 and is not an "action" organization as set forth in paragraph (c)(3) of § 1.501(c)(3)–1.

(ii) *Political or social activities.* The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office. Nor is an organization operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations which are operated for profit. See, however, section 501(c)(6) and § 1.501(c)(6)–1, relating to business leagues and similar organizations. A social welfare organization may qualify under section 501(c)(4) even though it is an "action" organization described in paragraph (c)(3)(ii) or (iv) of § 1.501(c)(3)–1 if it otherwise qualifies under this section.

(b) *Local associations of employees.* Local associations of employees described in section 501(c)(4) are expressly entitled to exemption under section 501(a). As conditions to exemption, it is required (1) that the membership of such an association be limited to the employees of a designated person or persons in a particular municipality, and (2) that the net earnings of the association be devoted exclusively to charitable, educational, or recreational purposes. The word "local" is defined in paragraph (b) of § 1.501(c)(12)–1. See paragraph (d)(2) and (3) of § 1.501(c)(3)–1 with reference to the meaning of "charitable" and "educational" as used in this section.

§ 1.501(c)(5) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; labor, agricultural, and horticultural organizations.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(5) Labor, agricultural, or horticultural organizations.

§ 1.501(c)(5)–1 Labor, agricultural, and horticultural organizations.

(a) The organizations contemplated by section 501(c)(5) as entitled to exemption from income taxation are those which:

(1) Have no net earnings inuring to the benefit of any member, and

(2) Have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

(b) Organizations described in section 501(c)(5) and otherwise exempt from tax under section 501(a) are taxable upon their unrelated business taxable income. See part II (section 511 and following), subchapter F, chapter 1 of the Code, and the regulations thereunder.

§ 1.501(c)(6) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; business leagues, chambers of commerce, real estate boards, and boards of trade.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(6) Business leagues, chambers of commerce, real-estate boards, or boards of trade not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

§ 1.501(c)(6)–1 Business leagues, chambers of commerce, real estate boards, and boards of trade.

A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not a business league, since its activities do not further any common business interest, even though all of its income is devoted to the purpose stated. A stock or commodity exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of section 501(c)(6) and is not exempt from tax. Organizations otherwise exempt from tax under this section are taxable upon their unrelated business taxable income. See part II (section 511 and following), subchapter F, chapter 1 of the Code, and the regulations thereunder.

§ 1.501(c)(7) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; social clubs.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(7) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder.

§ 1.501(c)(7)–1 Social clubs.

(a) The exemption provided by section 501(a) for organizations described in section 501(c)(7) applies only to clubs which are organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, but does not apply to any club if any part of its net earnings inures to the benefit of any private shareholder. In general, this exemption extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.

(b) A club which engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber, or other products, is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, and is not exempt under section 501(a). Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes. However, an incidental sale of property will not deprive a club of its exemption.

§ 1.501(c)(8) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; fraternal beneficiary societies.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(8) Fraternal beneficiary societies, orders, or associations—

(A) Operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and

(B) Providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

§ 1.501(c)(8)–1 Fraternal beneficiary societies.

(a) A fraternal beneficiary society is exempt from tax only if operated under the "lodge system" or for the exclusive benefit of the members so operating. "Operating under the lodge system" means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits.

(b) To be exempt a fraternal beneficiary society must be operated in furtherance of its fraternal purposes and may not engage in business activities of a kind carried on for profit, except that the carrying on of activities which raise revenues from members and their guests will not deprive the society of its exemption.

§ 1.501(c)(9) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; voluntary employees' beneficiary associations.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(9) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents, if—

(A) No part of their net earnings inures (other than through such payments) to the benefit of any private shareholder or individual, and

(B) 85 percent or more of the income consists of amounts collected from members and amounts contributed to the association by the employer of the members for the sole purpose of making such payments and meeting expenses.

§ 1.501(c)(10) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; voluntary employees' beneficiary associations.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(10) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or their designated beneficiaries, if—

(A) Admission to membership in such association is limited to individuals who are officers or employees of the United States Government, and

(B) No part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

§ 1.501(c)(11) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; teachers' retirement fund associations.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(11) Teachers' retirement funds associations of a purely local character, if—

(A) No part of their net earnings inures (other than through payment of retirement benefits) to the benefit of any private shareholder or individual, and

(B) The income consists solely of amounts received from public taxation, amounts received from assessments on the teaching salaries of members, and income in respect of investments.

§ 1.501(c)(12) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(12) Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

§ 1.501(c)(12)–1 Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.

(a) An organization described in section 501(c)(12) must receive at least 85 percent of its income from amounts collected from members for the sole purpose of meeting losses and expenses. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15 percent of its income is derived, it is not entitled to exemption. On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

(b) The phrase "of a purely local character" applies to benevolent life insurance associations, and not to the other organizations specified in section 501 (c) (12). It also applies to any organization seeking exemption on the ground that it is an organization similar to a benevolent life insurance association. An organization of a purely local character is one whose business activities are confined to a particular community, place, or district, irrespective, however, of political subdivisions. If the activities of an organization are limited only by the borders of a State it cannot be considered to be purely local in character.

§ 1.501(c)(13) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; cemetery companies.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(13) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

§ 1.501(c)(13)–1 Cemetery companies.

(a) A cemetery company may be entitled to exemption—

(1) If it is owned by and operated exclusively for the benefit of its lot owners who hold such lots for bona fide burial purposes and not for purpose of resale, or

(2) If it is not operated for profit.

(b) Any cemetery corporation chartered solely for burial purposes and not permitted by its charter to engage in any business not necessarily incident to that purpose is exempt from income tax, provided that no part of its net earnings inures to the benefit of any private shareholder or individual. A cemetery company which fulfills the other requirements of section 501 (c) (13) may be exempt, even though it issues preferred stock entitling the holders to dividends at a fixed rate, not exceeding the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, provided that its articles of incorporation require:

(1) That the preferred stock shall be retired at par as soon as sufficient funds available therefor are realized from sales, and

(2) That all funds not required for the payment of dividends upon or for the retirement of preferred stock shall be used by the company for the care and improvement of the cemetery property.

§ 1.501(c)(14) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; credit unions.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(14) Credit unions without capital stock organized and operated for mutual purposes and without profit; and corporations or associations without capital stock organized before September 1, 1951, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of, shares or deposits in—

(A) Domestic building and loan associations,

(B) Cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(C) Mutual savings banks not having capital stock represented by shares.

§ 1.501(c)(14)–1 Credit unions and mutual insurance funds.

Credit unions (other than Federal credit unions described in section 501(c)(1)) without capital stock, organized and operated for mutual purposes and without profit, are exempt from tax under section 501 (a). Corporations or associations without capital stock organized before September 1, 1951, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of, shares or deposits in:

(a) Domestic building and loan associations as defined in section 7701 (a)(19),

(b) Cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(c) Mutual savings banks not having capital stock represented by shares,

are also exempt from tax under section 501 (a).

§ 1.501(c)(15) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; mutual insurance organizations other than life or marine.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(15) Mutual insurance companies or associations other than life or marine (including interinsurers and reciprocal underwriters) if the gross amount received during the taxable year from the items described in section 822 (b) (other than paragraph (1) (D) thereof) and premiums (including deposits and assessments) does not exceed $75,000.

[Sec. 501 (c) (15) as amended by the Life Insurance Company Tax Act for 1955 (70 Stat. 49)]

§ 1.501(c)(15)–1 Mutual insurance companies or associations.

(a) *Taxable years beginning after December 31, 1954.* An insurance company or association described in section 501(c)(15) is exempt under section 501(a) if it is a mutual company or association (other than life or marine) or if it is a mutual interinsurer or reciprocal underwriter (other than life or marine) and if the gross amount received during the taxable year from the sum of the following items does not exceed $75,000:

(1) Interest, dividends, rents, and royalties,

(2) The entering into of any lease, mortgage, or other instrument or agreement from which the insurance company derives interest, rents, or royalties,

(3) The alteration or termination of any instrument or agreement described in subparagraph (2) of this paragraph, and

(4) Premiums (including deposits and assessments).

(b) *Taxable years beginning after December 31 1953, and before January 1, 1955.* An insurance company or association described in section 501 (c) (15) is exempt under section 501 (a) if it is a mutual company or association (other than life or marine) or if it is a mutual interinsurer or reciprocal underwriter (other than life or marine) and if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000.

§ 1.501(c)(16) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; corporations organized to finance crop operations.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(16) Corporations organized by an association subject to part III of this subchapter or members thereof, for the purpose of financing the ordinary crop operations of such members or other producers, and operated in conjunction with such association. Exemption shall not be denied any such corporation because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the corporation, on dissolution or otherwise, beyond the fixed dividends) is owned by such association, or members thereof; nor shall exemption be denied any such corporation because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

§ 1.501(c)(16)–1 Corporations organized to finance crop operations.

A corporation organized by a farmers' cooperative marketing or purchasing association, or the members thereof, for the purpose of financing the ordinary crop operations of such members or other producers is exempt, provided the marketing or purchasing association is exempt under section 521 and the financing corporation is operated in conjunction with the marketing or purchasing association. The provisions of § 1.521–1 relating to a reserve or surplus and to capital stock shall also apply to corporations coming under this section.

§ 1.501(d) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; religious and apostolic organizations.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(d) *Religious and apostolic organizations.* The following organizations are referred to in subsection (a): Religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for such year. Any amount so included in the gross income of a member shall be treated as a dividend received.

§ 1.501(d)–1 Religious and apostolic associations or corporations.

(a) Religious or apostolic associations or corporations are described in section 501(d) and are exempt from taxation under section 501(a) if they have a common treasury or community treasury, even though they engage in business for the common benefit of the members, provided each of the members includes (at the time of filing his return) in his gross income his entire pro rata share, whether distributed or not, of the net income of the association or corporation for the taxable year of the association or corporation ending with or during his taxable year. Any amount so included in the gross income of a member shall be treated as a dividend received.

(b) For annual return requirements of organizations described in section 501 (d), see section 6033 and paragraph (a) (5) of § 1.6033–1.

§ 1.501(e) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; cross reference.

SEC. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(e) *Cross reference.* For nonexemption of Communist-controlled organizations, see section 11 (b) of the Internal Security Act of 1950 (64 Stat. 997; 50 U. S. C. 790 (b)).

§ 1.501(e)–1 Communist-controlled organizations.

Under section 11(b) of the Internal Security Act of 1950 (50 U.S.C. 790(b)), as amended, which is made applicable to the Code by section 7852(b) of that Code, no organization is entitled to exemption under sections 501(a) or 521 (a) for any taxable year if at any time during such year such organization is registered under section 7 of such Act or if there is in effect a final order of the Subversive Activities Control Board established by section 12 of such Act requiring such organization to register under section 7 of such Act, or determining that it is a Communist-infiltrated organization.

§ 1.502 Statutory provisions; feeder organizations.

SEC. 502. *Feeder organizations.* An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to one or more organizations exempt under section 501 from taxation. For purposes of this section, the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

§ 1.502–1 Feeder organizations.

(a) In the case of an organization operated for the primary purpose of carrying on a trade or business for profit, exemption is not allowed under section 501 on the ground that all the profits of such organization are payable to one or more organizations exempt from taxation under section 501. For the purpose of this rule, the term "trade or business" does not include the rental by an organization of its real property (including personal property leased with the real property). In determining the primary purpose of an organization, all the circumstances must be considered, including the size and extent of the trade

or business and the size and extent of those activities of such organization which are specified in the applicable paragraph of section 501.

(b) If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization, for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the subsidiary is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.

(c) In certain cases an organization which carries on a trade or business for profit but is not operated for the primary purpose of carrying on such trade or business is subject to the tax imposed under section 511 on its unrelated business taxable income.

§ 1.503(a) Statutory provisions; requirements for exemption; denial of exemption to organizations engaged in prohibited transactions.

SEC. 503. *Requirements for exemption*—(a) *Denial of exemption to organizations engaged in prohibited transactions*—(1) *General rule.* An organization described in section 501 (c) (3) which is subject to the provisions of this section shall not be exempt from taxation under section 501 (a) if it has engaged in a prohibited transaction after July 1, 1950; and an organization described in section 401 (a) which is subject to the provisions of this section shall not be exempt from taxation under section 501 (a) if it has engaged in a prohibited transaction after March 1, 1954.

(2) *Taxable years affected.* An organization described in section 501 (c) (3) or section 401 (a) shall be denied exemption from taxation under section 501 (a) by reason of paragraph (1) only for taxable years after the taxable year during which it is notified by the Secretary or his delegate that it has engaged in a prohibited transaction, unless such organization entered into such prohibited transaction with the purpose of diverting corpus or income of the organization from its exempt purposes, and such transaction involved a substantial part of the corpus or income of such organization.

§ 1.503(a)–1 Denial of exemption to organizations engaged in prohibited transactions.

(a) The prohibited transactions enumerated in section 503(c) are in addition to and not in limitation of the restrictions contained in section 501(c) (3) and section 401 (a). Even though an organization has not engaged in any of the prohibited transactions referred to in section 503 (c), it still may not qualify for tax exemption in view of the general provisions of section 501 (c) (3) and section 401 (a). Thus, if a trustee or other fiduciary of the organization (whether or not he is also a creator of such organization) enters into a transaction with the organization, such transaction will be closely scrutinized in the light of the fiduciary principle requiring undivided loyalty to ascertain whether the organization is in fact being operated for the stated exempt purposes.

(b) An organization described in section 501 (c) (3) which after July 1, 1950, has engaged in any prohibited transaction as defined in section 503 (c), unless it is excepted by the provisions of section 503 (b), and an organization described in section 401 (a) which after March 1, 1954, has engaged in any such prohibited transaction shall not be exempt from taxation under section 501 (a) for any taxable year subsequent to the taxable year in which there is mailed to it a notice in writing by the Commissioner that it has engaged in such prohibited transaction. Such notification by the Commissioner shall be by registered or certified mail to the last known address of the organization. However, notwithstanding the requirement of notification by the Commissioner, exemption shall be denied with respect to any taxable year if such organization during or prior to such taxable year commenced the prohibited transaction with the purpose of diverting income or corpus from its exempt purposes and such transaction involved a substantial part of the income or corpus of such organization. For the purpose of this section, the term "taxable year" means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the "taxable year" of the organization means the calendar year.

(c) The application of section 503 (c) may be illustrated by the following examples:

Example (1). A creates a foundation in 1954 ostensibly for educational purposes. B, a trustee, accumulates the foundation's income from 1957 until 1959 and then uses a substantial part of this accumulated income to send A's children to college. The foundation would lose its exemption for the taxable years 1957 through 1959 and for subsequent taxable years until it regains its exempt status.

Example (2). If under the facts in example (1) such private benefit was the purpose of the foundation from its inception, such foundation is not exempt by reason of the general provisions of section 501 (c) (3), without regard to the provisions of section 503, for all years since its inception, that is, for the taxable years 1954 through 1959 and subsequent taxable years, since under section 501 (c) (3) the organization must be organized and operated exclusively for exempt purposes. See § 1.501 (c) (3)–1. See also § 1.504–1 for loss of exemption in the case of certain organizations accumulating income.

§ 1.503(b) Statutory provisions; requirements for exemption; organizations to which section 503 applies.

SEC. 503. *Requirements for exemption.* • • •

(b) *Organizations to which section applies.* This section shall apply to any organization described in section 501 (c) (3) or section 401 (a) except—

(1) A religious organization (other than a trust);

(2) An educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on;

(3) An organization which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (a)) from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public;

(4) An organization which is operated, supervised, controlled, or principally supported by a religious organization (other than a trust) which is itself not subject to the provisions of this section; and

(5) An organization the principal purposes or functions of which are the providing of medical or hospital care or medical education or medical research or agricultural research.

§ 1.503(c) Statutory provisions; requirements for exemption; prohibited transactions.

SEC. 503. *Requirements for exemption.* • • •

(c) *Prohibited transactions.* For purposes of this section, the term "prohibited transaction" means any transaction in which an organization subject to the provisions of this section—

(1) Lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;

(2) Pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

(3) Makes any part of its services available on a preferential basis to;

(4) Makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;

(5) Sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

(6) Engages in any other transaction which results in a substantial diversion of its income or corpus to;

the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in section 267 (c) (4)) of an individual who is the creator of such trust or who has made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

§ 1.503(c)–1 Prohibited transactions.

(a) *In general.* The term "prohibited transaction" means any transaction set forth in section 503 (c) en-

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gaged in by an organization described in section 501 (c) (3) or section 401 (a) sidered, for purposes of section 503 (c)

gaged in by an organization described in section 501 (c) (3) or section 401 (a), other than those organizations excepted by section 503 (b). Whether a transaction is a prohibited transaction depends on the facts and circumstances of the particular case. This section is intended to deny tax-exempt status to those organizations described in sections 501 (c) (3) and 401 (a) which engage in certain transactions which inure to the private advantage of (1) the creator of such organization (if it is a trust); (2) any substantial contributor to the organization; (3) a member of the family (as defined in section 267 (c) (4)) of an individual who is such creator of or such substantial contributor to such organization; or (4) a corporation controlled, as set forth in section 503 (c), by such creator or substantial contributor.

(b) *Loans as prohibited transactions under section 503 (c) (1)*—(1) *Adequate security.* For the purposes of section 503 (c) (1), which treats as prohibited transactions certain loans by an organization without receipt of adequate security and a reasonable rate of interest, the term "adequate security" means something in addition to and supporting a promise to pay, which is so pledged to the organization that it may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan. Mortgages or liens on property, accommodation endorsements of those financially capable of meeting the indebtedness, and stock or securities issued by corporations other than the borrower may constitute security for a loan to the persons or organizations described in section 503 (c). Stock of a borrowing corporation does not constitute adequate security. A borrower's evidence of indebtedness, irrespective of its name, is itself not security for a loan, whether or not it was issued directly to the exempt organization. However, if any such evidence of indebtedness provides for security that may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, there may be adequate security for such loan. If an organization subject to section 503 (c) purchases debentures issued by a person specified in section 503 (c), the purchase is considered, for purposes of section 503 (c) (1), as a loan made by the purchaser to the issuer on the date of such purchase. For example, if an exempt organization subject to section 503 (c) makes a purchase through a registered security exchange of debentures issued by a person described in section 503 (c), and owned by an unknown third party, the purchase will be considered as a loan to the issuer by the purchaser. For rules relating to loan of funds to, or investment of funds in stock or securities of, persons described in section 503 (c) by an organization described in section 401 (a), see paragraph (b) (5) of § 1.401–1.

(2) *Effective dates.* The effective dates for the application of the definition of adequate security in subparagraph (1) of this paragraph are:

(i) March 15, 1956, for loans (other than debentures) made after March 15, 1956;

(ii) January 31, 1957, for loans (other than debentures) made before March 16, 1956, and continued after January 31, 1957;

(iii) November 8, 1956, for debentures which were purchased after November 8, 1956;

(iv) December 1, 1958, for debentures which were purchased before November 9, 1956, and held after December 1, 1958;

(v) If an employees' pension, stock bonus, or profit-sharing trust described in section 401 (a) made a loan before March 1, 1954, repayable by its terms after December 31, 1955, and which would constitute a prohibited transaction if made on or after March 1, 1954, the loan shall not constitute a prohibited transaction if held until maturity (determined without regard to any extension or renewal thereof).

(c) *Examples.* The following examples illustrate the operation of section 503 (c) (1):

Example (1). A, creator of an exempt trust subject to section 503, borrows $100,000 from such trust in 1960, giving his unsecured promissory note. The net worth of A is $1,000,000. The net worth of A is not "security" for such loan and the transaction is a prohibited transaction. If, however, the note is secured by a mortgage on property of sufficient value, or is accompanied by acceptable collateral of sufficient value, or carries with it the secondary promise of repayment by an accommodation endorser financially capable of meeting the indebtedness, it may be adequately secured. However, subordinated debenture bonds of a partnership which are guaranteed by the general partners are not adequately secured since the general partners are liable for the firm's debt and their guaranty adds no additional security.

Example (2). Assume the same facts as in example (1) except that A's promissory note in the amount of $100,000 to the trust is secured by property which has a fair market value of $75,000. A's promissory note secured to the extent o $75,000 is not adequately secured within the meaning of section 503 (c) (1) since the security at the time of the transaction must be sufficient to repay the indebtedness, interest, and charges which may pertain thereto.

Example (3). Corporation M, a substantial contributor to an exempt organization subject to section 503, borrows $150,000 from such organization in 1960, giving its promissory note accompanied by stock of the borrowing corporation with a fair market value of $200,000. Since promissory notes and debentures have priority over stock in the event of liquidation of the corporation, stock of a borrowing corporation may not be adequate security. Likewise, debenture bonds which are convertible on default into voting stock of the issuing corporation may not constitute "adequate security" under section 503 (c) (1).

Example (4). B, creator of an exempt trust subject to section 503, borrows $100,000 from such trust in 1960, giving his secured promissory note at the rate of 3 percent interest. The prevailing rate of interest charged by financial institutions in the community where the transaction takes place is 5 percent for a loan of the same duration and similarly secured. The loan by the trust to the grantor is a prohibited transaction since section 503 (c) (1) requires both adequate security and a reasonable rate of interest. Further, a promise to repay the loan plus a percentage of future profits which may be greater than the prevailing rate of interest does not meet the reasonable rate of interest requirement.

Example (5). N Corporation, a substantial contributor to an exempt organization subject to section 503, borrows $50,000 on or after March 16, 1956, from the organization. If the loan is not adequately secured, the organization has committed a prohibited transaction at the time the loan was made. If the loan had been made on or before March 15, 1956, and is continued after January 31, 1957, it must be adequately secured on February 1, 1957, or it will be considered a prohibited transaction on that date. However, if the exempt organization were an employees' trust, described in section 401 (a), and the loan were made before March 1, 1954, repayable by its terms after December 31, 1955, it would not have to be adequately secured on February 1, 1957.

Example (6). An exempt organization subject to section 503 purchases a debenture issued by O Corporation, which is a substantial contributor to the organization. The organization purchases the debenture in an arm's length transaction from a third person on or after November 9, 1956. The purchase is considered as a loan by the organization to O Corporation and the loan must be adequately secured when it is made, or it is considered as a prohibited transaction at that time. If the organization purchased the debenture before November 9, 1956, and holds it after December 1, 1958, the debenture must be adequately secured on December 2, 1958, or it will be then considered as a prohibited transaction. However, if the organization were an employees' trust described in section 401(a), and if the debenture were purchased before March 1, 1954, and its maturity date is after December 31, 1955, the debenture does not have to be adequately secured.

§ 1.503(d) Statutory provisions; requirements for exemption; future status of organizations denied exemption.

SEC. 503. *Requirements for exemption.*

* * *

(d) *Future status of organizations denied exemption.* Any organization described in section 501 (c) (3) or section 401 (a) which is denied exemption under section 501 (a) by reason of subsection (a) of this section, with respect to any taxable year following the taxable year in which notice of denial of exemption was received, may, under regulations prescribed by the Secretary or his delegate, file claim for exemption, and if the Secretary or his delegate, pursuant to such regulations, is satisfied that such organization will not knowingly again engage in a prohibited transaction, such organization shall be exempt with respect to taxable years after the year in which such claim is filed.

§ 1.503(d)–1 Future status of organizations denied exemption.

(a) Any organization described in section 501(c)(3) or an employees' trust described in section 401(a), which is denied exemption under section 501(a) by reason of the provisions of section 503 (a), may file, in any taxable year following the taxable year in which notice of denial was issued, a claim for exemption. Form 1023, the exemption application, shall be used for this purpose in the case of an organization described in section 501(c)(3), and shall be filed with the district director for the internal revenue district in which is located the principal place of business or principal office of the organization claiming exemption. In the case of an employees'

trust described in section 401 (a), the information described in § 1.404 (a)–2 shall be submitted with a letter claiming exemption. An employees' trust described in section 401 (a) shall submit this information to the district director with whom a request for a determination as to its qualification under section 401 and exemption under section 501 may be submitted under paragraph (l) of § 601.201 of this chapter (Statement of Procedural Rules). A claim for exemption must contain or have attached to it, in addition to the information generally required of such an organization claiming exemption as an organization described in section 501 (c) (3) or 401 (a), a written declaration made under the penalties of perjury by a principal officer of such organization authorized to make such declaration that the organization will not knowingly again engage in a prohibited transaction. See § 1.501 (a)–1 for proof of exemption requirements in general.

(b) If the Commissioner is satisfied that such organization will not knowingly again engage in a prohibited transaction and that the organization also satisfies all other requirements under section 501 (c) (3) or section 401 (a), the organization will be so notified in writing. In such case the organization will be exempt (subject to the provisions of sections 501 (c) (3), 401 (a), 503, and 504) with respect to the taxable years subsequent to the taxable year in which the claim prescribed in section 503 (d) is filed. Section 503 contemplates that an organization denied exemption because of the terms of such section will be subject to taxation for at least one full taxable year. For the purpose of this section, the term "taxable year" means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the "taxable year" of the organization means the calendar year.

§ 1.503(d)–2 Fiscal years and short taxable years ending after March 1, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in §§ 1.503 (a)–1 to 1.503(d)–1, inclusive, as they relate to the denial of exemption to organizations described in section 401 (a) engaged in prohibited transactions after March 1, 1954, shall also apply to taxable years beginning after December 31, 1953, and ending after March 1, 1954, but before August 17, 1954, and to taxable years beginning before January 1, 1954, and ending after March 1, 1954, which years are subject to the Internal Revenue Code of 1939.

§ 1.503(e) Statutory provisions; requirements for exemption; disallowance of certain charitable, etc., deductions.

SEC. 503. *Requirements for exemption.* • • •

(e) *Disallowance of certain charitable, etc., deductions.* No gift or bequest for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and the prevention of cruelty to children or animals), otherwise allowable as a deduction under section 170, 642 (c), 545 (b) (2), • • • shall be allowed as a deduction if made to an organization described in section 501 (c) (3) which, in the taxable year of the organization in which the gift or bequest is made, is not exempt under section 501 (a) by reason of this section. With respect to any taxable year of the organization for which the organization is not exempt pursuant to subsection (a) by reason of having engaged in a prohibited transaction with the purpose of diverting the corpus or income of such organization from its exempt purposes and such transaction involved a substantial part of such corpus or income, and which taxable year is the same, or prior to the, taxable year of the organization in which such transaction occurred, such deduction shall be disallowed the donor only if such donor or (if such donor is an individual) any member of his family (as defined in section 267 (c) (4)) was a party to such prohibited transaction.

§ 1.503(e)–1 Disallowance of certain charitable deductions.

(a) No gift or contribution which would otherwise be allowable as a charitable or other deduction under section 170, 642(c), or 545(b)(2) shall be allowed as a deduction if made to an organization described in section 501(c)3) which at the time the gift or contribution is made is not exempt under section 501(a) by reason of the provisions of section 503.

(b) If an organization which is described in section 501 (c) (3) is not exempt because it engaged in a prohibited transaction involving a substantial part of its income or corpus with the purpose of diverting its income or corpus from its exempt purposes, and if the organization receives a gift or contribution during, or prior to, its taxable year in which such prohibited transaction occurred, then a deduction by the donor with respect to the gift or contribution shall not be disallowed under section 503 (e) unless the donor (or any member of his family if the donor is an individual) is a party to such prohibited transaction. For the purpose of the preceding sentence, "family" is defined in section 267 (c) (4) and includes brothers and sisters, whether by whole or half blood, spouse, ancestors, and lineal descendants. See the regulations under section 267 (c).

(c) The application of section 503 (e) may be illustrated by the following example:

Example. In 1954, Corporation M, which files its income tax returns on the calendar year basis, creates a foundation purportedly for charitable purposes and deducts from its gross income for that year the amount of the gift to the foundation. Corporation M makes additional gifts to this foundation in 1955, 1956, and 1957, and takes charitable deductions for such years. B, an individual, also contributes to the foundation in 1955, 1956, and 1957, and takes charitable deductions for such years. In 1955, the foundation commences purposely to divert its corpus to the benefit of Corporation M, and a substantial amount of such corpus is so diverted by the close of the taxable year 1956. For 1955 and subsequent taxable years, the exemption allowed the foundation as an organization described in section 501 (c) (3) is denied by reason of the provisions of section 503 (a). Both Corporation M and individual B would be disallowed any deduction for the contributions made during 1957 to the foundation. Moreover, the charitable deductions taken by Corporation M for contributions to the foundation in the years 1955 and 1956 would also be disallowed since Corporation M was a party to the prohibited transaction. If the facts and surrounding circumstances indicate that the contribution in 1954 by Corporation M was for the purpose of the prohibited transaction, then the charitable deduction for the year 1954 shall also be disallowed with respect to Corporation M, since the prohibited transaction would then have commenced with the making of such contribution and the exemption allowed the foundation would then be denied for 1954 by reason of the provisions of section 503 (e). B's deductions for his contributions for the years 1955 and 1956 will not be disallowed since he was not a party to the prohibited transaction.

§ 1.503(f) Statutory provisions; requirements for exemption; definition.

SEC. 503. *Requirements for exemption.* • • •

(f) *Definition.* For purposes of this section, the term "gift or bequest" means any gift, contribution, bequest, devise, legacy, or transfer.

§ 1.503(g) Statutory provisions; requirements for exemption; special rule for loans.

SEC. 503. *Requirements for exemption.* • • •

(g) *Special rule for loans.* For purposes of the application of subsection (c) (1), in the case of a loan by a trust described in section 401 (a), the following rules shall apply with respect to a loan made before March 1, 1954, which would constitute a prohibited transaction if made on or after March 1, 1954:

(1) If any part of the loan is repayable prior to December 31, 1955, the renewal of such part of the loan for a period not extending beyond December 31, 1955, on the same terms, shall not be considered a prohibited transaction.

(2) If the loan is repayable on demand, the continuation of the loan without the receipt of adequate security and a reasonable rate of interest beyond December 31, 1955, shall be considered a prohibited transaction.

§ 1.503(g)–1 Cross reference.

For provisions relating to loans by a trust described in section 401(a), see § 1.503(c)–1.

§ 1.504 Statutory provisions; denial of exemption.

SEC. 504. *Denial of exemption*—(a) *General rule.* In the case of any organization described in section 501 (c) (3) to which section 503 is applicable, exemption under section 501 shall be denied for the taxable year if the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) Are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for exemption under section 501 (a) of an organization described in section 501 (c) (3); or

(2) Are used to a substantial degree for purposes or functions other than those constituting the basis for exemption under section 501 (a) of an organization described in section 501 (c) (3); or

(3) Are invested in such a manner as to jeopardize the carrying out of the charitable, educational, or other purpose or function constituting the basis for exemption under section 501 (a) of an organization described in section 501 (c) (3).

Paragraph (1) shall not apply to income attributable to property of a decedent dying before January 1, 1951, which is transferred under his will to a trust created by such will. In the case of a trust created by the will of a decedent dying on or after January 1, 1951, if income is required to be accumulated pursuant to the mandatory terms of the will creating the trust, paragraph (1) shall apply only to income accumulated during a taxable

created by such will. In the case of

creating the trust, paragraph (1) shall apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

(b) *Cross references.* For the limitation on charitable contributions in case of unreasonable accumulations by certain trusts, see section 681 (c) (2).

§ 1.504–1 Denial of exemption.

(a) The restrictions enumerated in section 504 are in addition to and not in limitation of the restrictions contained in section 501(c)(3). Even though an organization has not violated any of the terms of section 504, it still may not qualify for tax exemption in view of the general provisions of section 501 (c) (3). Thus, if a trustee or other fiduciary of the organization (whether or not he is also a creator of such organization) enters into a transaction with the organization, such transaction will be closely scrutinized in the light of the fiduciary principle requiring undivided loyalty to ascertain whether the organization is in fact being operated for the stated exempt purposes.

(b) (1) Any organization described in section 501 (c) (3) other than an organization described in section 503 (b) (1) through (5), inclusive, shall not be exempt under section 501 (a) if the amounts accumulated out of income during the taxable year, or any prior taxable year, and not actually paid out for exempt purposes by the end of the taxable year, are unreasonable. Amounts accumulated out of income become unreasonable when more income is accumulated than is needed, or when the duration of the accumulation is longer than is needed in order to carry out the purpose constituting the basis for the organization's exemption. Furthermore, such an organization shall not be exempt under section 501 (a) if amounts accumulated out of income are used to a substantial degree for purposes or functions other than those constituting the basis for the organization's exemption, or if such amounts are invested in such a manner as to jeopardize the carrying out of the purpose or function constituting the basis for the organization's exemption.

(2) The provisions for the denial of exemption for unreasonable accumulations of income will not apply to income attributable to property of a decedent dying before January 1, 1951, which is transferred under his will to a trust created by such will. In the case of a trust created by the will of a decedent dying on or after January 1, 1951, where income is required to be accumulated by the trust, the denial of exemption for unreasonable accumulations of income under paragraph (b)(1) of this section will apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

(c) For the purpose of section 504, the term "income" means gains, profits, and income determined under the principles applicable in determining the earnings or profits of a corporation. The amount accumulated out of income during the taxable year or any prior taxable year shall be determined under the principles applicable in determining the accumulated earnings or profits of a corporation. In determining the reasonableness of an accumulation out of income, there will be disregarded the following:

(1) The accumulation of gain upon the sale or exchange of a donated asset to the extent that such gain represents the excess of the fair market value of such asset when acquired by the organization over its substituted basis in the hands of the organization;

(2) The accumulation of gain upon the sale or exchange of property held for the production of investment income, such as dividends, interest, and rents, where the proceeds of such sale or exchange are within a reasonable time reinvested in property acquired and held in good faith for the production of investment income.

(d) Whether the conditions specified in paragraphs (1), (2), and (3) of section 504 (a) are present in any case must be determined from all the facts. The conditions specified in section 504 (a) (1), (2), and (3) may result from the use of only one organization or of a chain of two or more organizations.

(e) An organization that has lost its exempt status by reason of the provisions of section 504 may, in order to reestablish its exemption, file a claim for exemption with the district director for the internal revenue district in which is located the principal place of business or principal office of the organization. Form 1023, the exemption application, shall be used for this purpose. The claim for exemption must contain or be accompanied by information or evidence showing that the circumstances that caused the loss of exemption under section 504 no longer exist, and a written declaration made under the penalties of perjury, by a principal officer of such organization authorized to make such declaration, that the organization will not knowingly again violate the terms of section 504. See § 1.501 (a)–1 for proof of exemption requirements in general. The provisions of section 504 contemplate that an organization denied exemption thereunder will be subject to taxation for at least one full taxable year. For the purpose of this section, the term "taxable year" means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the "taxable year" of the organization means the calendar year.

(f) In the case of an organization described in section 501 (c) (3) denied exemption under section 501 (a) solely by reason of the provisions of section 504, deductions otherwise allowable under section 170, 545 (b) (2), or 642 (c) for gifts or contributions to such organization shall not be disallowed for the year during which the exemption is denied and prior years.

Taxation of Business Income of Certain Exempt Organizations

§ 1.511 Statutory provisions; imposition of tax on unrelated business income of charitable, etc., organizations.

Sec. 511. *Imposition of tax on unrelated business income of charitable, etc., organizations*—(a) *Charitable, etc., organizations taxable at corporation rates*—(1) *Imposition of tax.* There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a normal tax and a surtax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income".

(2) *Organizations subject to tax*—(A) *Organizations described in section 501 (c) (2), (3), (5), and (6), and section 401 (a).* The taxes imposed by paragraph (1) shall apply in the case of any organization (other than a church, a convention or association of churches, or a trust described in subsection (b)) which is exempt, except as provided in this part, from taxation under this subtitle by reason of section 401 (a) or of paragraph (3), (5), or (6) of section 501 (c). Such taxes shall also apply in the case of a corporation described in section 501 (c) (2) if the income is payable to an organization which itself is subject to the taxes imposed by paragraph (1) or to a church or to a convention or association of churches.

(B) *State colleges and universities.* The taxes imposed by paragraph (1) shall apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions. Such taxes shall also apply in the case of any corporation wholly owned by one or more such colleges or universities.

(b) *Tax on charitable, etc., trusts*—(1) *Imposition of tax.* There is hereby imposed for each taxable year on the unrelated business taxable income of every trust described in paragraph (2) a tax computed as provided in section 1. In making such computation for purposes of this section, the term "taxable income" as used in section 1 shall be read as "unrelated business taxable income" as defined in section 512.

(2) *Charitable, etc., trusts subject to tax.* The tax imposed by paragraph (1) shall apply in the case of any trust which is exempt, except as provided in this part, from taxation under this subtitle by reason of section 501 (c) (3) or section 401 (a) and which, if it were not for such exemption, would be subject to subchapter J (sec. 641 and following, relating to estates, trusts, beneficiaries, and decedents).

(c) *Effective date.* The tax imposed by this section shall apply, in the case of a trust described in section 401 (a), only for taxable years beginning after June 30, 1954.

§ 1.511–1 Imposition and rates of tax.

Section 511(a) imposes a tax upon the unrelated business taxable income of certain organizations otherwise exempt from Federal income tax. Under section 511 (a) (1), organizations described in section 511 (a) (2) (A) and in paragraph (a) of § 1.511–2 and organizations described in section 511 (a) (2) (B) are subject to normal tax and surtax at the corporate rates provided by section 11. Under section 511 (b) (1), trusts described in section 511 (b) (2) are subject to tax at the individual rates prescribed in section 1. The deduction for personal exemption provided in section 642 (b) in the case of a trust taxable under subchapter J, chapter 1 of the Code, is not allowed in computing unrelated business taxable income.

§ 1.511–2 Organizations subject to tax.

(a) (1) The taxes imposed by section 511(a)(1) apply in the case of any or-

ganization (other than a church, a convention or association of churches, or a trust described in section 511(b)(2)) which is exempt (except as provided in sections 511 through 515) from taxation under section 501(a) as an organization described in section 501(c) (3), (5), or (6), or section 401 (a). A corporation described in section 501 (c) (2) exempt from taxation under section 501 (a) holding property for an organization which itself is subject to the tax or for a church or a convention or association of churches, is also subject to the tax imposed by section 511 (a) (1).

(2) The taxes imposed by section 511 (a) apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof or by any agency or instrumentality of any one or more governments or political subdivisions. Such taxes also apply in the case of any corporation wholly owned by one or more such colleges or universities. As here used, the word "government" includes any foreign government (to the extent not contrary to any treaty obligation of the United States) and all domestic governments (the United States and any of its Territories or possessions, any State, and the District of Columbia). Elementary and secondary schools operated by such governments are not subject to the tax on unrelated business income.

(3) (i) Churches and associations or conventions of churches are exempt from the tax imposed by section 511. The exemption is applicable only to an organization which itself is a church or an association or convention of churches. Subject to the provisions of subdivision (ii) of this subparagraph, religious organizations, including religious orders, if not themselves churches or associations or conventions of churches, and all other organizations which are organized or operated under church auspices, are subject to the tax imposed by section 511, whether or not they engage in religious, educational, or charitable activities approved by a church.

(ii) The term "church" includes a religious order or a religious organization if such order or organization (*a*) is an integral part of a church, and (*b*) is engaged in carrying out the functions of a church, whether as a civil law corporation or otherwise. In determining whether a religious order or organization is an integral part of a church, consideration will be given to the degree to which it is connected with, and controlled by, such church. A religious order or organization shall be considered to be engaged in carrying out the functions of a church if its duties include the ministration of sacerdotal functions and the conduct of religious worship. If a religious order or organization is not an integral part of a church, or if such an order or organization is not authorized to carry out the functions of a church (ministration of sacerdotal functions and conduct of religious worship) then it is subject to the tax imposed by section 511 whether or not it engages in religious, educational, or charitable activities approved by a church. What constitutes the conduct of religious worship or the ministration of sacerdotal functions depends on the tenets and practices of a particular religious body constituting a church. If a religious order or organization can fully meet the requirements stated in this subdivision, exemption from the tax imposed by section 511 will apply to all its activities, including those which it conducts through a separate corporation (other than a corporation described in section 501 (c) (2)) or other separate entity which it wholly owns and which is not operated for the primary purpose of carrying on a trade or business for profit. Such exemption from tax will also apply to activities conducted through a separate corporation (other than a corporation described in section 501 (c) (2)) or other separate entity which is wholly owned by more than one religious order or organization, if all such orders or organizations fully meet the requirements stated in this subdivision and if such corporation or other entity is not operated for the primary purpose of carrying on a trade or business for profit.

(b) The taxes imposed by section 511 (b) apply in the case of any trust which is exempt (except as provided in sections 511 through 515) from taxation under section 501 (a) as an organization described in section 501 (c) (3) or section 401 (a) and which, if it were not for such exemption, would be subject to the provisions of subchapter J, chapter 1, of the Code. In the case of a trust described in section 401(a), the tax imposed by section 511(b) and this section shall apply only for taxable years beginning after June 30, 1954. An organization which is considered as "trustee" of a stock bonus, pension, or profit-sharing plan described in section 401(a) (regardless of the form of such organization) is subject to the taxes imposed by section 511 (b) (1) on its unrelated business taxable income. However, if such an organization conducts a business which is a separate taxable entity on the basis of all the facts and circumstances, for example, as a corporation or an association taxable as a corporation, the business will be taxable as a feeder organization described in section 502.

§ 1.511–3 Provisions generally applicable to the tax on unrelated business income.

(a) *Assessment and collections.* Since the taxes imposed by section 511 are taxes imposed by subtitle A of the Code, all provisions of law and of the regulations applicable to the taxes imposed by subtitle A are applicable to the assessment and collection of the taxes imposed by section 511. Organizations subject to the tax imposed by section 511 (a) (1) are subject to the same provisions, including penalties, as are provided in the case of the income tax of other corporations. In the case of a trust subject to the tax imposed by section 511 (b) (1), the fiduciaries for such trust are subject to the same provisions, including penalties, as are applicable to fiduciaries in the case of the income tax of other trusts. See section 6151, et seq., and the regulations prescribed thereunder, for provisions relating to payment of tax.

(b) *Returns.* For requirements of filing annual returns with respect to unrelated business taxable income by organizations subject to the tax on such income, see section 6012, paragraph (e) of § 1.6012–2, and paragraph (a) (5) of § 1.6012–3.

(c) *Taxable years, method of accounting, etc.* The taxable year (fiscal year or calendar year, as the case may be) of an organization shall be determined without regard to the fact that such organization may have been exempt from tax during any prior period. See sections 441 and 446, and the regulations thereunder in this part, and section 7701 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration). Similarly, in computing unrelated business taxable income, the determination of the taxable year for which an item of income or expense is taken into account shall be made under the provisions of sections 441, 446, 451, and 461, and the regulations thereunder, whether or not the item arose during a taxable year beginning before, on, or after the effective date of the provisions imposing a tax upon unrelated business taxable income. If a method for treating bad debts was selected in a return of income (other than an information return) for a previous taxable year, the taxpayer must follow such method in its returns under section 511, unless such method is changed in accordance with the provisions of § 1.166–1. A taxpayer which has not previously selected a method for treating bad debts may, in its first return under section 511, exercise the option granted in § 1.166–1.

(d) *Foreign tax credit.* See section 515 for provisions applicable to the credit for foreign taxes provided in section 901.

§ 1.512(a) Statutory provisions; unrelated business taxable income; definition.

SEC. 512. *Unrelated business taxable income*—(a) *Definition.* The term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the exceptions, additions, and limitations provided in subsection (b). In the case of an organization described in section 511 which is a foreign organization, the unrelated business taxable income shall be its unrelated business taxable income derived from sources within the United States determined under subchapter N (sec. 861 and following, relating to tax based on income from sources within or without the United States).

§ 1.512(a)–1 Definition; general rule.

The unrelated business taxable income which is subject to the tax imposed by section 511 is the gross income, derived by any organization to which section 511 applies, from any unrelated trade or business regularly carried on by it, less the deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade

or business, subject to certain exceptions, additions, and limitations referred to below. In the case of an organization which regularly carries on two or more unrelated businesses, its unrelated business taxable income is the aggregate of its gross income from all such unrelated businesses, less the aggregate of the deductions allowed with respect to all such unrelated businesses. For provisions generally applicable to the unrelated business tax, see § 1.511–3, and for rules applicable to the determination of the adjusted basis of property, see paragraph (a) (2) of § 1.514 (a)–1.

§ 1.512(b) Statutory provisions; unrelated business taxable income; exceptions, additions, and limitations.

SEC. 512. *Unrelated business taxable income.* * * *

(b) *Exceptions, additions, and limitations.* The exceptions, additions, and limitations applicable in determining unrelated business taxable income are the following:

(1) There shall be excluded all dividends, interest, and annuities, and all deductions directly connected with such income.

(2) There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

(3) There shall be excluded all rents from real property (including personal property leased with the real property), and all deductions directly connected with such rents.

(4) Notwithstanding paragraph (3), in the case of a business lease (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514 (a) (1), and there shall be allowed, as a deduction, the amount ascertained under section 514 (a) (2).

(5) There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than—

(A) Stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or

(B) Property held primarily for sale to customers in the ordinary course of the trade or business.

This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

(6) The net operating loss deduction provided in section 172 shall be allowed, except that—

(A) The net operating loss for any taxable year, the amount of the net operating loss carryback or carryover to any taxable year, and the net operating loss deduction for any taxable year shall be determined under section 172 without taking into account any amount of income or deduction which is excluded under this part in computing the unrelated business taxable income; and

(B) The terms "preceding taxable year" and "preceding taxable years" as used in section 172 shall not include any taxable year for which the organization was not subject to the provisions of this part.

(7) There shall be excluded all income derived from research for (A) the United States, or any of its agencies or instrumentalities, or (B) any State or political subdivision thereof; and there shall be excluded all deductions directly connected with such income.

(8) In the case of a college, university, or hospital, there shall be excluded all income derived from research performed for any person, and all deductions directly connected with such income.

(9) In the case of an organization operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public, there shall be excluded all income derived from research performed for any person, and all deductions directly connected with such income.

(10) In the case of any organization described in section 511 (a), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), but shall not exceed 5 percent of the unrelated business taxable income computed without the benefit of this paragraph.

(11) In the case of any trust described in section 511 (b), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed with the limitations prescribed in section 170 (b) (1) (A) and (B) determined with reference to the unrelated business taxable income computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

(12) There shall be allowed a specific deduction of $1,000.

§ 1.512(b)–1 Exceptions, additions, and limitations.

Whether a particular item of income falls within any of the exceptions, additions, and limitations provided in secton 512(b) shall be determined by all the facts and circumstances of each case. For example, if a payment termed "rent" by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or a joint venturer, such payment is not within the exception for rent. The exceptions, additions, and limitations provided in section 512 (b) are as follows:

(a) *Dividends, interest, and annuities.* All dividends, interest, and annuities, and the deductions directly connected therewith, shall be excluded in computing unrelated business taxable income.

(b) *Royalties.* Royalties, including overriding royalties, and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income. Mineral royalties shall be excluded whether measured by production or by gross or taxable income from the mineral property. However, where an organization owns a working interest in a mineral property, and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded. In-oil payments shall be treated in the same manner as royalty payments for the purpose of computing unrelated business taxable income.

(c) *Rents.* (1) Rents from real property (including personal property leased with the real property) and the deductions directly connected therewith shall also be excluded in computing unrelated business taxable income, except that certain rents from, and certain deductions in connection with, a business lease (as defined in section 514 (a)) shall be included in computing unrelated business taxable income. See §§ 1.514 (a)–1 and 1.514 (a)–2.

(2) Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rentals from real estate. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in an office building, etc., are generally rentals from real estate.

(d) *Gains and losses from the sale, etc., of property.* There shall also be excluded from the computation of unrelated business taxable income gains or losses from the sale, exchange, or other disposition of property other than (1) stock in trade or other property of a kind which would properly be included in the inventory of the organization if on hand at the close of the taxable year, or (2) property held primarily for sale to customers in the ordinary course of the trade or business. This exclusion does not apply with respect to the cutting of timber which is considered, upon the application of section 631 (a), as a sale or exchange of such timber. The exclusion under section 512 (b) (5) applies with respect to gains and losses from involuntary conversions, casualties, etc.

(e) *Net operating losses.* (1) The net operating loss deduction provided in section 172 shall be allowed in computing unrelated business taxable income. However, the net operating loss carryback or carryover (from a taxable year for which the taxpayer is subject to the provisions of section 511) shall be determined under section 172 without taking into account any amount of income or deduction which is not included under section 511 in computing unrelated business taxable income. For example, a loss attributable to an unrelated trade or business shall not be diminished by reason of the receipt of dividend income.

(2) For the purpose of computing the net operating loss deduction provided by section 172, any prior taxable year for which an organization was not subject to the provisions of section 511, or a corresponding provision of prior law, shall not be taken into account. Thus, if the organization was not subject to the provisions of section 511 or Supplement U of the Internal Revenue Code of 1939

for a preceding taxable year, the net operating loss is not a carryback to such preceding taxable year, and the net operating loss carryover to succeeding taxable years is not reduced by the taxable income for such preceding taxable year.

(3) A net operating loss carryback or carryover shall be allowed only from a taxable year for which the taxpayer is subject to the provisions of section 511, or a corresponding provision of prior law.

(4) In determining the span of years for which a net operating loss may be carried for purposes of section 172, taxable years in which an organization was not subject to the provisions of section 511 or a corresponding provision of prior law shall be taken into account. Thus, for example, if an organization is subject to the provisions of section 511 for the taxable year 1955 and has a net operating loss for that year, the last taxable year to which any part thereof may be carried over is the year 1960 regardless of whether the organization is subject to the provisions of section 511 in any of the intervening taxable years.

(f) *Research.* (1) Income derived from research for the United States or any of its agencies or instrumentalities or a State or political subdivision thereof, and all deductions directly connected with such income, shall be excluded in computing unrelated business taxable income.

(2) In the case of a college, university, or hospital, all income derived from research performed for any person and all deductions directly connected with such income, shall be excluded in computing unrelated business taxable income.

(3) In the case of an organization operated primarily for the purpose of carrying on fundamental research (as distinguished from applied research) the results of which are freely available to the general public, all income derived from research performed for any person and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income.

(4) For the purpose of § 1.512 (a)–1 and this section, the term "research" does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc. The term "fundamental research" does not include research carried on for the primary purpose of commercial or industrial application.

(g) *Charitable, etc., contributions.* (1) In computing the unrelated business taxable income of an organization described in section 511 (a) (2) the deduction from gross income allowed by section 170 (relating to charitable contributions and gifts) shall be allowed, whether or not the contribution is directly connected with the carrying on of the trade or business. Section 512 (b) (10) provides that this deduction shall not exceed 5 percent of the organization's unrelated business taxable income computed without regard to that deduction. The provisions of section 170 (b) (2) are not applicable to contributions by the organizations described in section 511 (a) (2).

(2) In computing the unrelated business taxable income of a trust described in section 511 (b) (2), the deduction allowed by section 170 (relating to charitable contributions and gifts) shall be allowed whether or not the contribution is directly connected with the carrying on of the trade or business. The deduction is limited as provided in section 170 (b) (1) (A) and (B), except that the amounts so allowed are determined on the basis of unrelated business taxable income computed without regard to this deduction (rather than on the basis of adjusted gross income). For purposes of this deduction, a distribution by a trust described in section 511 (b) (2) made pursuant to the trust instrument to a beneficiary described in section 170 shall be treated in the same manner as gifts or contributions.

(3) The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a university described in section 501 (c) (3) which is exempt from tax and which operates an unrelated business, shall be allowed a deduction, not in excess of 5 percent of its unrelated business taxable income, for gifts or contributions to another university described in section 501 (c) (3) for educational work but shall not be allowed any deduction for amounts expended in administering its own educational program.

(h) *Specific deduction.* In computing unrelated business taxable income a deduction from gross income of $1,000 is allowed.

§ 1.512(c) Statutory provisions; unrelated business taxable income; special rules applicable to partnerships.

SEC. 512. *Unrelated business taxable income.* * * *

(c) *Special rules applicable to partnerships.* If a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in subsection (b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income. If the taxable year of the organization is different from that of the partnership, the amounts to be so included or deducted in computing the unrelated business taxable income shall be based upon the income and deductions of the partnership for any taxable year of the partnership ending within or with the taxable year of the organization.

§ 1.512(c)–1 Special rules applicable to partnerships; in general.

In the event an organization to which section 511 applies is a member of a partnership regularly engaged in a trade or business which is an unrelated trade or business with respect to such organization, the organization shall include in computing its unrelated business taxable income so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto. For this purpose, both the gross income and the deductions shall be computed with the necessary adjustments for the exceptions, additions, and limitations referred to in section 512(b) and in § 1.512(b)–1. For example, if an exempt educational institution is a partner in a partnership which operates a factory and if such partnership also holds stock in a corporation, the exempt organization shall include in computing its unrelated business taxable income its share of the gross income from the operation of the factory, but not its share of any dividends received by the partnership from the corporation. If the taxable year of the organization differs from that of the partnership, the amounts included or deducted in computing unrelated business taxable income shall be based upon the income and deductions of the partnership for each taxable year of the partnership ending within or with the taxable year of the organization.

§ 1.513 Statutory provisions; unrelated trade or business.

SEC. 513. *Unrelated trade or business*—(a) *General rule.* The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511 (a) (2) (B), to the exercise or performance of any purpose or function described in section 501 (c) (3)), except that such term does not include any trade or business—

(1) In which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) Which is carried on, in the case of an organization described in section 501 (c) (3) or in the case of a college or university described in section 511 (a) (2) (B), by the organization primarily for the convenience of its members, students, patients, officers, or employees; or

(3) Which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

(b) *Special rule for trusts.* The term "unrelated trade or business" means, in the case of—

(1) A trust computing its unrelated business taxable income under section 512 for purposes of section 681; or

(2) A trust described in section 401 (a) which is exempt from tax under section 501 (a);

any trade or business regularly carried on by such trust or by a partnership of which it is a member.

(c) *Special rule for certain publishing businesses.* If a publishing business carried on by an organization during a taxable year beginning before January 1, 1953, is, without regard to this subsection, an unrelated trade or business, but before the beginning of the third succeeding taxable year the business is carried on by it (or by a successor who acquired such business in a liquidation which would have constituted a tax-free exchange under section 112 (b) (6) of the Internal Revenue Code of 1939) in such manner that the conduct thereof is substantially related to the exercise or performance by such organization (or such successor) of its educational

or other purpose or function described in

or other purpose or function described in section 501 (c) (3), such publishing business shall not be considered, for the taxable year, as an unrelated trade or business.

§ 1.513–1 Definition of unrelated trade or business.

(a) *In general.* (1) As used in section 512(a), the term "unrelated business taxable income" includes only income from an unrelated trade or business regularly carried on, and the term "trade or business" has the same meaning as it has in section 162.

(2) The income of an exempt organization is subject to the tax on unrelated business income only if two conditions are present with respect to such income. The first condition is that the income must be from a trade or business which is regularly carried on by the organization. The second condition is that the trade or business must not be substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501, or, in the case of an organization described in section 511 (a) (2) (B) (governmental colleges, etc.) to the exercise or performance of any purpose or function described in section 501 (c) (3). Whether or not an organization is subject to the tax imposed by section 511 shall be determined by the application of these tests to the particular circumstances involved in each individual case. For certain exceptions from the term "unrelated trade or business", see paragraph (b) of this section.

(3) A trade or business is regularly carried on when the activity is conducted with sufficient consistency to indicate a continuing purpose of the organization to derive some of its income from such activity. An activity may be regularly carried on even though its performance is infrequent or seasonal.

(4) Ordinarily, a trade or business is substantially related to the activities for which an organization is granted exemption if the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. In the usual case the nature and size of the trade or business must be compared with the nature and extent of the activities for which the organization is granted exemption in order to determine whether the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. For example, the operation of a wheat farm is substantially related to the exempt activity of an agricultural college if the wheat farm is operated as a part of the educational program of the college, and is not operated on a scale disproportionately large when compared with the educational program of the college. Similarly, a university radio station or press is considered a related trade or business if operated primarily as an integral part of the educational program of the university, but is considered an unrelated trade or business if operated in substantially the same manner as a commercial radio station or publishing house. A trade or business not otherwise related does not become substantially related to an organization's exempt purpose merely because incidental use is made of the trade or business in order to further the exempt purpose. For example, the manufacture and sale of a product by an exempt college would not become substantially related merely because students as part of their educational program perform clerical or bookkeeping functions in the business. In some cases, the business may be substantially related because it is a necessary part of the exempt activity. For example, in the case of an organization described in section 501 (c) (3) and engaged in the rehabilitation of handicapped persons, the business of selling articles made by such persons as a part of their rehabilitation training would not be considered an unrelated business since such business is a necessary part of the rehabilitation program.

(b) *Exceptions.* Section 513 (a) specifically states that the term "unrelated trade or business" does not include—

(1) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) Any trade or business carried on by an organization described in section 501 (c) (3) or by a governmental college or university described in section 511 (a) (2) (B), primarily for the convenience of its members, students, patients, officers, or employees; or

(3) Any trade or business which consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.

An example of the operation of the first of the exceptions mentioned above would be an exempt orphanage operating a retail store and selling to the general public, where substantially all the work in carrying on such business is performed for the organization by volunteers without compensation. An example of the second exception would be a laundry operated by a college for the purpose of laundering dormitory linens and the clothing of students. The third exception applies to so-called "thrift shops" operated by a tax-exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, etc., to be sold to the general public with the proceeds going to the exempt organization.

(c) *Special rule respecting publishing businesses.* For a special rule with respect to publishing businesses carried on by an organization, see section 513 (c).

§ 1.514(a) Statutory provisions; business leases; business lease rents and deductions.

SEC. 514. *Business leases*—(a) *Business lease rents and deductions.* In computing under section 512 the unrelated business taxable income for any taxable year—

(1) *Percentage of rents taken into account.* There shall be included with respect to each business lease, as an item of gross income derived from an unrelated trade or business, an amount which is the same percentage (but not in excess of 100 percent) of the total rents derived during the taxable year under such lease as (A) the business lease indebtedness, at the close of the taxable year, with respect to the premises covered by such lease is of (B) the adjusted basis, at the close of the taxable year, of such premises.

(2) *Percentage of deductions taken into account.* There shall be allowed with respect to each business lease, as a deduction to be taken into account in computing unrelated business taxable income, an amount determined by applying the percentage derived under paragraph (1) to the sum determined under paragraph (3).

(3) *Deductions allowable.* The sum referred to in paragraph (2) is the sum of the following deductions allowable under this chapter:

(A) Taxes and other expenses paid or accrued during the taxable year on or with respect to the real property subject to the business lease.

(B) Interest paid or accrued during the taxable year on the business lease indebtedness.

(C) A reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) of the real property subject to such lease.

Where only a portion of the real property is subject to the business lease, there shall be taken into account under subparagraphs (A), (B), and (C) only those amounts which are properly allocable to the premises covered by such lease.

§ 1.514(a)–1 Business lease rents.

(a) *In general*—(1) *Rents includible in gross income.* There shall be included with respect to each business lease, as an item of gross income derived from an unrelated trade or business, an amount which is the same percentage (but not in excess of 100 percent) of the total rents derived during the taxable year under such lease as—

(i) The amount of the business lease indebtedness at the close of the taxable year of the lessor tax-exempt organization, with respect to the premises covered by such lease, is of

(ii) The adjusted basis of such premises at the close of such taxable year.

For definition of business lease as a lease for a term of more than 5 years, and for rules for determining the computation of such 5-year term in certain specific situations, see § 1.514 (b)–1. For definition of business lease indebtedness and allocation of business lease indebtedness where only a portion of the property is subject to a business lease, see § 1.514 (c)–1.

(2) *Determination of basis.* For purposes of the unrelated business income tax the basis (unadjusted) of property is determined under section 1012, and the adjusted basis of property is determined under section 1011. The determination of the adjusted basis of property is not affected by the fact that the organization was exempt from tax for prior taxable years. Proper adjustment must be made under section 1011 for the entire period since the acquisition of the property. Thus, adjustment must be made for depreciation for all prior taxable years whether or not the organization was exempt from tax for any of such years. Similarly, for taxable years during which the organization is subject to the tax on

unrelated business taxable income the fact that only a portion of the deduction for depreciation is taken into account under section 514 (a) (2) does not affect the amount of the adjustment for depreciation.

(b) *Examples.* The application of this section may be illustrated by the following examples, in each of which it is assumed that the taxpayer makes its returns under section 511 on the basis of the calendar year, and that the lease is not substantially related to the purpose for which the organization is granted exemption from tax.

Example (1). Assume that a tax-exempt educational organization purchased property in 1942 for $600,000, using borrowed funds, and leased the building for a period of 20 years. Assume further that the adjusted basis of such building at the close of 1954 is $500,000 and that, at the close of 1954, $200,000 of the indebtedness incurred to acquire the property remains outstanding. Since the amount of the outstanding indebtedness is two-fifths of the adjusted basis of the building at the close of 1954, two-fifths of the gross rental received from the building during 1954 shall be included as an item of gross income in computing unrelated business taxable income. If, at the close of a subsequent taxable year, the outstanding indebtedness is $100,000 and the adjusted basis of the building is $400,000, one-fourth of the gross rental for such taxable year shall be included as an item of gross income in computing unrelated business taxable income for such taxable year.

Example (2). Assume that a tax-exempt organization owns a 4-story building, that in 1954 it borrows $100,000 which it uses to improve the whole building, and that it thereafter in 1954 rents the first and second floors of the building under 6-year leases at rentals of $4,000 a year. The third and fourth floors of the building are leased on a yearly basis during 1954. Assume, also, that the adjusted basis of the real property at the end of 1954 (after reflecting the expenditures for improving the building) is $200,000, allocable equally to each of the 4 stories. Under these facts, only one-half of the real property is subject to a business lease since only one-half is rented under a lease for more than five years. See § 1.514 (b)-1. The percentage of the rent under such lease which is taken into account is determined by the ratio which the allocable part of the business lease indebtedness bears to the allocable part of the adjusted basis of the real property, that is, the ratio which one-half of the $100,000 of business lease indebtedness outstanding at the close of 1954, or $50,000, bears to one-half of the adjusted basis of the business lease premises at the close of 1954, or $100,000. The percentage of rent which is business lease income for 1954 is, therefore, one-half (the ratio of $50,000 to $100,000) of $8,000, or $4,000, and this amount of $4,000 is considered an item of gross income derived from an unrelated trade or business.

§ 1.514(a)-2 Business lease deductions.

(a) The same percentage is used in determining both the portion of the rent and the portion of the deductions taken into account with respect to the business lease in computing unrelated business taxable income. See § 1.514 (a)-1 for the determination of such percentage. Such percentage is applicable only to the sum of the following deductions allowable under section 161:

(1) Taxes and other expenses paid or accrued during the taxable year upon or with respect to the real property subject to the business lease;

(2) Interest paid or accrued during the taxable year on the business lease indebtedness;

(3) A reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) of the real property subject to such lease.

Where only a portion of the real property is subject to the business lease, there shall be taken into account only those amounts of the above-listed deductions which are properly allocable to the premises covered by such lease.

(b) The deductions allowable under section 514 (a) (3) and under paragraph (a) of this section with respect to a business lease are not limited by the amount included in gross income with respect to the rent from such lease, but any excess of such deductions over such gross income shall be applied against other items of gross income in computing unrelated business taxable income taxable under section 511 (a).

(c) The application of this section may be illustrated by the following example:

Example. Assume the same facts as those in example (1) in paragraph (b) of § 1.514 (a)-1. Assume, also, that for 1954 the organization pays taxes of $4,000 on the property, interest of $6,000 on its business lease indebtedness, and that the depreciation allowable for 1954 under section 167 is $10,000. Under the facts set forth in such example (1) and in this example, the deductions to be taken into account for 1954 in computing unrelated business taxable income would be two-fifths of the total of the deductions of $20,000, that is, $8,000.

§ 1.514(b) Statutory provisions; business leases; definition of business lease.

SEC. 514. *Business leases.* • • •

(b) *Definition of business lease*—(1) *General rule.* For purposes of this section, the term "business lease" means a lease for a term of more than 5 years of real property by an organization (or by a partnership of which it is a member), if at the close of the lessor's taxable year there is a business lease indebtedness (as defined in subsection (c)) with respect to such property.

(2) *Special rules for applying paragraph (1).* For purposes of paragraph (1)—

(A) In computing the term of a lease which contains an option for renewal or extension, the term of such lease shall be considered as including any period for which such option may be exercised; and the term of any lease made pursuant to an exercise of such option shall include the period during which the prior lease was in effect. If real property is acquired subject to a lease, the term of such lease shall be considered to begin on the date of such acquisition.

(B) If the property has been occupied by the same lessee for a total period of more than 5 years commencing not earlier than the date of acquisition of the property by the organization or trust (whether such occupancy is under one or more leases, renewals, extensions, or continuations thereof), the occupancy of such lessee shall be considered to be under a lease for a term of more than 5 years within the meaning of paragraph (1). However, subsection (a) shall apply in the case of a tenancy described in this subparagraph (and not within subparagraph (A)) only with respect to the sixth and succeeding years of occupancy by the same lessee. For purposes of this subparagraph, the term "same lessee" shall include any lessee of the property whose relationship with a lessee of the same property is such that losses in respect of sales or exchanges of property between the 2 lessees would be disallowed under section 267 (a).

(3) *Exceptions.* (A) No lease shall be considered a business lease if—

(i) Such lease is entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501, or

(ii) The lease is of premises in a building primarily designed for occupancy, and occupied, by the organization.

(B) If a lease for more than 5 years to a tenant is for only a portion of the real property, and space in the real property is rented during the taxable year under a lease for not more than 5 years to any other tenant of the organization, leases of the real property for more than five years shall be considered as business leases during the taxable year only if—

(i) The rents derived from the real property during the taxable year under leases for more than 5 years (not including, as a lease for more than 5 years, an occupancy which is considered as such a lease by reason of paragraph (2) (B)) represent 50 percent or more of the total rents derived during the taxable year from the real property; or the area of the premises occupied under leases for more than 5 years (not including, as a lease for more than 5 years, an occupancy which is considered as such a lease by reason of paragraph (2) (B)) represents, at any time during the taxable year, 50 percent or more of the total area of the real property rented at such time; or

(ii) The rent derived from the real property during the taxable year from any tenant under a lease for more than 5 years (including as a lease for more than 5 years an occupancy which is considered as such a lease by reason of paragraph (2) (B)), or from a group of tenants (under such leases) who are either members of an affiliated group (as defined in section 1504) or partners, represents more than 10 percent of the total rents derived during the taxable year from such property; or the area of the premises occupied by any one such tenant, or by any such group of tenants, represents at any time during the taxable year more than 10 percent of the total area of the real property rented at such time.

In the application of clause (i), if during the last half of the term of a lease a new lease is made to take effect after the expiration of such lease, the unexpired portion of such lease on the date the second lease is made shall not be treated as a part of the term of the second lease.

§ 1.514(b)-1 Definition of business lease.

(a) *In general.* The term "business lease" means any lease, with certain exceptions discussed in paragraph (c) of this section, for a term of more than five years of real property by an organization subject to section 511 (or by a partnership of which it is a member) if at the close of the organization's taxable year there is a business lease indebtedness as defined in section 514 (c) and § 1.514 (c)-1 with respect to such property. For the purpose of section 514, the term "real property" and the term "premises" include personal property of the lessor tax-exempt organization leased by it to a lessee of its real estate if the lease of such personal property is made under, or in connection with, the lease of such real estate. For amounts of business lease

rents and deductions to be included in computing unrelated business taxable income, see §§ 1.514 (a)–1 and 1.514 (a)–2.

(b) *Special rules.* (1) In computing the term of the lease, the period for which a lease may be renewed or extended by reason of an option contained therein shall be considered as part of the term. For example, a 3-year lease with an option for renewal for another such period is considered a lease for a term of six years. Another example is the case of a 1-year lease with option of renewal for another such term, where the parties at the end of each year renew the arrangement. In this case, during the fifth year (but not during the first four years), the lease falls within the 5-year rule, since the lease then involves five years and there is an option for the sixth year. In determining the term of the lease, an option for renewal of the lease is taken into account whether or not the exercise of the option depends upon conditions or contingencies.

(2) If the property is acquired subject to a lease, the term of such lease shall be considered to begin on the date of such acquisition. For example, if an exempt organization purchases, in whole or in part with borrowed funds, real property subject to a 10-year lease which has three years left to run, and such lease contains no right of renewal or extension, the lease shall be considered a 3-year lease and hence does not meet the definition of a business lease in section 514 (b) and paragraph (a) of this section. However, if this lease contains an option to renew for a period of three years or more, it is a business lease.

(3) Under the provisions of section 514 (b) (2) (B) a lease is considered as continuing for more than five years if the same lessee has occupied the premises for a total period of more than five years, whether the occupancy is under one or more leases, renewals, extensions, or continuations. Continued occupancy shall be considered to be by the same lessee if the occupants during the period are so related that losses in respect of sales or exchanges of property between them would be disallowed under section 267 (a). Such period shall be considered as commencing not earlier than the date of the acquisition of the property by the tax-exempt organization or trust. This rule is applicable only in the sixth and succeeding years of such occupancy by the same lessee. See, however, paragraph (c) (3) of this section.

(c) *Exceptions.* (1) A lease shall not be considered a business lease if such lease is entered into primarily for a purpose which is substantially related (aside from the need of such organization for income or funds, or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption. For example, where a tax-exempt hospital leases real property owned by it to an association of doctors for use as a clinic, the rents derived under such lease would not be included in computing unrelated business taxable income if the clinic is substantially related to the carrying on of hospital functions. See § 1.513–1 for principles applicable in determining whether there is a substantial relationship to the exempt purposes of an organization.

(2) A lease is not a business lease if the lease is of premises in a building primarily designed for occupancy and occupied by the tax-exempt organization.

(3) If a lease for more than five years to a tenant is for only a portion of the real property, and space in the real property is rented during the taxable year under a lease for not more than five years to any other tenant of the tax-exempt organization, all leases of the real property for more than five years shall be considered as business leases during the taxable year only if—

(i) The rents derived from the real property during the taxable year under leases for more than five years represent 50 percent or more of the total rents derived during the taxable year from the real property; or the area of the premises occupied under leases for more than five years represents, at any time during the taxable year, 50 percent or more of the total area of the real property rented at such time; or

(ii) The rent derived from the real property during the taxable year from any tenant under a lease for more than five years, or from a group of tenants (under such leases) who are either members of an affiliated group (as defined in section 1504) or are partners, represents more than 10 percent of the total rents derived during the taxable year from such property; or the area of the premises occupied by any one such tenant, or by any such group of tenants, represents at any time during the taxable year more than 10 percent of the total area of the real property rented at such time.

In determining whether 50 percent or more of the total rents are derived from leases for more than 5 years, or whether 50 percent or more of the total area is occupied under leases for more than 5 years—

(iii) An occupancy which is considered to be a lease of more than five years solely by reason of the provisions of paragraph (b) (3) of this section shall not be treated as such a lease for purposes of subdivision (i) of this subparagraph, and

(iv) An occupancy which is considered to be a lease of more than five years solely by reason of the provisions of paragraph (b) (3) of this section shall be treated as such a lease for purposes of subdivision (ii) of this subparagraph, and

(v) If during the last half of the term of a lease a new lease is made to take effect after the expiration of such lease, the unexpired portion of the first lease will not be added to the second lease to determine whether such second lease is a lease for more than 5 years for purposes of subdivision (i) of this subparagraph.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example. In 1954 an educational organization, which is on the calendar year basis, begins the erection of an 11-story apartment building using funds borrowed for that purpose, and immediately leases for a 10-year term the first floor to a real estate development company to sublet for stores and shops. As fast as the new apartments are completed, they are rented on an annual basis. At the end of 1959 all except the tenth and eleventh floors are rented. Those two floors are completed during 1960 and rented. Assume that for 1954 and each subsequent taxable year through 1959, and for the taxable year 1963, the gross rental for the first floor represents more than 10 percent of the total gross rents derived during the taxable year from the building. Under this set of facts the 10-year lease of the first floor would be considered to be a business lease for all except the taxable years 1961, 1962, and 1964.

§ 1.514(c) Statutory provisions; business leases; business lease indebtedness.

SEC. 514. *Business leases.* • • •

(c) *Business lease indebtedness*—(1) *General rule.* The term "business lease indebtedness" means, with respect to any real property leased for a term of more than 5 years, the unpaid amount of—

(A) The indebtedness incurred by the lessor in acquiring or improving such property;

(B) The indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(C) The indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

(2) *Property acquired subject to mortgage, etc.* Where real property is acquired subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien shall be considered (whether the acquisition was by gift, devise, or purchase) as an indebtedness of the lessor incurred in acquiring such property even though the lessor did not assume or agree to pay such indebtedness, except that where real property was acquired by gift, bequest, or devise before July 1, 1950, subject to a mortgage or other similar lien, the amount of such mortgage or other similar lien shall not be considered as an indebtedness of the lessor incurred in acquiring such property.

(3) *Certain property acquired by gift, etc.* Where real property was acquired by gift, bequest, or devise before July 1, 1950, subject to a lease requiring improvements in such property on the happening of stated contingencies, indebtedness incurred in improving such property in accordance with the terms of such lease shall not be considered as an indebtedness for purposes of this subsection.

(4) *Certain corporations described in section 501 (c) (2).* In the case of a corporation described in section 501 (c) (2), all of the stock of which was acquired before July 1, 1950, by an organization described in paragraph (3), (5), or (6) of section 501 (c) (and more than one-third of such stock was acquired by such organization by gift or bequest), any indebtedness incurred by such corporation before July 1, 1950, and any indebtedness incurred by such corporation on or after such date in improving real property in accordance with the terms of a lease entered into before such date, shall not be considered as an indebtedness with respect to such corporation or such organization for purposes of this subsection.

(5) *Certain trusts described in section 401 (a).* In the case of a trust described in section 401 (a), or in the case of a corporation described in section 501 (c) (2) all of the stock of which was acquired prior to March 1, 1954, by a trust described in section 401 (a), any indebtedness incurred by such trust or such corporation before March 1, 1954, in connection with real property which is leased before March 1, 1954, and any indebtedness incurred by such trust or such corporation on or after such date necessary to carry out the terms of such lease, shall not be considered as an indebtedness with respect to such trust or such corporation for purposes of this subsection.

(6) *Business lease on portion of property.* In determining the amount of the business lease indebtedness where only a portion of the real property is subject to a business lease, proper allocation to the premises covered by such lease shall be made of the indebtedness incurred by the lessor with respect to the real property.

(7) *Special rule applicable to trusts described in section 401 (a).* In the application of paragraph (1), if a trust described in section 401 (a) forming part of a stock bonus, pension, or profit-sharing plan of an employer lends any money to another trust described in section 401 (a) forming part of a stock bonus, pension, or profit-sharing plan of the same employer, such loan shall not be treated as an indebtedness of the borrowing trust, except to the extent that the loaning trust—

(A) Incurs any indebtedness in order to make such loan;

(B) Incurred indebtedness before the making of such loan which would not have been incurred but for the making of such loan; or

(C) Incurred indebtedness after the making of such loan which would not have been incurred but for the making of such loan and which was reasonably foreseeable at the time of making such loan.

§ 1.514(c)–1 Business lease indebtedness.

(a) *Definition.* The term "business lease indebtedness" means, with respect to any real property leased by a tax-exempt organization for a term of more than five years, the unpaid amount of—

(1) The indebtedness incurred by the lessor tax-exempt organization in acquiring or improving such property;

(2) The indebtedness incurred by the lessor tax-exempt organization prior to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(3) The indebtedness incurred by the lessor tax-exempt organization subsequent to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of the indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

See paragraph (i) of this section with respect to subsidiary corporations.

(b) *Examples.* The rules of section 514 (c) respecting business leases also cover certain cases where the leased property itself is not subject to an indebtedness. For example, they apply to cases such as the following:

Example (1). A university pledges some of its investment securities with a bank for a loan and uses the proceeds of such loan to purchase (either directly or through a subsidiary corporation) a building, which building is subject to a lease that then has more than five years to run. This would be an example of a business lease indebtedness incurred prior to the acquisition of the property which would not have been incurred but for such acquisition.

Example (2). If the building itself in example (1) in this paragraph is later mortgaged to raise funds to release the pledged securities, the lease would continue to be a business lease.

Example (3). If a scientific organization mortgages its laboratory building to replace working capital used in remodeling another one of its buildings or a building held by its subsidiary corporation, which other building is free of indebtedness and is subject to a lease that then has more than five years to run, the lease would be a business lease inasmuch as the indebtedness though incurred subsequent to the improvement of such property would not have been incurred but for such improvement, and the incurrence of the indebtedness was reasonably foreseeable when, to make such improvement, the organization reduced its working capital below the amount necessary to continue current operations.

(c) *Property acquired subject to lien.* Where real property is acquired subject to a mortgage or similar lien, whether the acquisition be by gift, bequest, devise, or purchase, the amount of the indebtedness secured by such mortgage or lien is a business lease indebtedness (unless paragraph (d) (1) of this section applies) even though the lessor does not assume or agree to pay the indebtedness. For example, a university pays $100,000 for real estate valued at $300,000 and subject to a $200,000 mortgage. For the purpose of the tax on unrelated business taxable income the result is the same as if $200,000 of borrowed funds had been used to buy the property.

(d) *Certain property acquired by gifts, etc.* (1) Where real property was acquired by gift, bequest, or devise, before July 1, 1950, subject to a mortgage or other similar lien, the amount of such mortgage or other similar lien shall not be considered as an indebtedness of the lessor tax-exempt organization incurred in acquiring such property. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(2) Where real property was acquired by gift, bequest, or devise, before July 1, 1950, subject to a lease requiring improvements in such property upon the happening of stated contingencies, indebtedness incurred in improving such property in accordance with the terms of such lease shall not be considered as indebtedness described in section 514 (c) and in this section. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(e) *Certain corporations described in section 501 (c) (2).* In the case of a title holding corporation described in section 501 (c) (2), all of the stock of which was acquired before July 1, 1950, by an organization described in section 501 (c) (3), (5), or (6) (and more than one-third of such stock was acquired by such organization by gift or bequest), any indebtedness incurred by such corporation before July 1, 1950, and any indebtedness incurred by such corporation on or after such date in improving real property in accordance with the terms of a lease entered into before such date, with respect to either such section 501 (c) (2) corporation or such section 501 (c) (3), (5), or (6) organization, shall not be considered an indebtedness described in section 514 (c) and in this section.

(f) *Certain trusts described in section 401 (a).* In the case of a trust described in section 401 (a), or in the case of a corporation described in section 501 (c) (2) all of the stock of which was acquired before March 1, 1954, by such a trust, any indebtedness incurred by such trust or such corporation before such date, in connection with real property which is leased before such date, and any indebtedness incurred by such trust or such corporation on or after such date necessary to carry out the terms of such lease, shall not be considered as an indebtedness described in section 514 (c) and in this section.

(g) *Business lease on portion of property.* Where only a portion of the real property is subject to a business lease, proper allocation of the indebtedness applicable to the whole property must be made to the premises covered by the lease. See example (2) of paragraph (b) of § 1.514 (a)–1.

(h) *Special rule applicable to trusts described in section 401 (a).* If an employees' trust described in section 401 (a) lends any money to another such employees' trust of the same employer, for the purpose of acquiring or improving real property, such loan will not be treated as an indebtedness of the borrowing trust except to the extent that the loaning trust—

(1) Incurs any indebtedness in order to make such loan;

(2) Incurred indebtedness before the making of such loan which would not have been incurred but for the making of such loan; or

(3) Incurred indebtedness after the making of such loan which would not have been incurred but for the making of such loan and which was reasonably foreseeable at the time of making such loan.

(i) *Subsidiary corporations.* The provisions of section 514 are applicable whether or not a subsidiary corporation of the type described in section 501 (c) (2) is availed of in making the business lease. For example, assume a parent organization borrows funds to purchase realty and sets up a separate section 501 (c) (2) corporation as a subsidiary to hold the property. Such subsidiary corporation leases the property for a period of more than five years, collects the rents and pays over all of the income, less expenses, to the parent organization, the parent organization being liable for the indebtedness. Under these assumed facts, the lease by the section 501 (c) (2) subsidiary corporation would be a business lease with respect to such subsidiary corporation, and the rental income would be subject to the tax, whether or not the subsidiary itself assumes the indebtedness and whether or not the property is subject to the indebtedness.

§ 1.514(d) Statutory provisions; business leases; personal property leased with real property.

SEC. 514. *Business leases.* * * *

(d) *Personal property leased with real property.* For purposes of this section, the term "real property" and the term "premises" include personal property of the lessor leased by it to a lessee of its real estate if the lease of such personal property is made under, or in connection with, the lease of such real estate.

§ 1.515 Statutory provisions; taxes of foreign countries and possessions of the United States.

SEC. 515. *Taxes of foreign countries and possessions of the United States.* The amount of taxes imposed by foreign countries and possessions of the United States shall be allowed as a credit against the tax of an organization subject to the tax imposed by section 511 to the extent provided in section 901; and in the case of the tax imposed by section 511, the term "taxable income" as used in section 901 shall be read as "unrelated business taxable income".

FARMERS' COOPERATIVES

§ 1.521 Statutory provisions; exemption of farmers' cooperatives from tax.

SEC. 521. *Exemption of farmers' cooperatives from tax*—(a) *Exemption from tax.* A farmers' cooperative organization described in subsection (b) (1) shall be exempt from taxation under this subtitle except as otherwise provided in section 522. Notwithstanding section 522, such an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.

(b) *Applicable rules*—(1) *Exempt farmers' cooperatives.* The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

(2) *Organizations having capital stock.* Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association.

(3) *Organizations maintaining reserve.* Exemption shall not be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

(4) *Transactions with nonmembers.* Exemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.

(5) *Business for the United States.* Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this section.

§ 1.521–1 Farmers' cooperative marketing and purchasing associations; requirements for exemption under section 521.

(a) (1) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, livestock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses, on the basis of either the quantity or the value of the products furnished by them, are exempt from income tax except as otherwise provided in section 522. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of either the quantity or the value of milk or of butterfat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Code and is not exempt. In other words, nonmember patrons must be treated the same as members insofar as the distribution of patronage dividends is concerned. Thus, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Code that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of either the quantity or the value of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Code does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While under the Code patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association, instead of paying patronage dividends to nonmember producers in cash, keeps permanent records from which the proportionate shares of the patronage dividends due to nonmember producers can be determined, and such shares are made applicable toward the purchase price of a share of stock or of a membership in the association.

(2) An association which has capital stock will not for such reason be denied exemption (i) if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and (ii) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends.

(3) The accumulation and maintenance of a reserve required by State statute, or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installation of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption. An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for nonmembers does not exceed the value of the products marketed for members. Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of section 521.

(b) Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, livestock growers, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. The term "supplies and equipment" as used in section 521 includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household. The provisions of paragraph (a) of this section relating to a reserve or surplus

and to capital stock shall apply to associations coming under this paragraph. An association which purchases supplies and equipment for nonmembers will not for such reason be denied exemption, provided the value of the purchases for nonmembers does not exceed the value of the supplies and equipment purchased for members, and provided the value of the purchases made for nonmembers who are not producers does not exceed 15 percent of the value of all its purchases.

(c) In order to be exempt under either paragraph (a) or (b) of this section an association must establish that it has no taxable income for its own account other than that reflected in a reserve or surplus authorized in paragraph (a) of this section. An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Code. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under section 521 and this section. An association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 521.

(d) Cooperative organizations engaged in occupations dissimilar from those of farmers, fruit growers, and the like, are not exempt.

(e) An organization is not exempt from taxation under this section merely because it claims that it complies with the requirements prescribed therein. In order to establish its exemption every organization claiming exemption under section 521 is required to file a Form 1028. The Form 1028, executed in accordance with the instructions on the form or issued therewith, should be filed with the district director for the internal revenue district in which is located the principal place of business or principal office of the organization. However, an organization which has been granted exemption under the provisions of the Internal Revenue Code of 1939 or prior law may rely on that ruling, unless affected by substantive changes in the Internal Revenue Code of 1954 or any changes in the character, purposes, or methods of operation of the organization, and it is not necessary in such case for the organization to request a new determination as to its exempt status.

§ 1.522 Statutory provisions; tax on farmers' cooperatives.

SEC. 522. *Tax on farmers' cooperatives*—(a) *Imposition of tax.* An organization exempt from taxation under section 521 shall be subject to the taxes imposed by section 11 or section 1201.

(b) *Computation of taxable income*—(1) *General rule.* In computing the taxable income of such an organization there shall be allowed as deductions from gross income (in addition to other deductions allowable under this chapter)—

(A) Amounts paid as dividends during the taxable year on its capital stock, and

(B) Amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. Allocations made after the close of the taxable year and on or before the 15th day of the 9th month following the close of such year shall be considered as made on the last day of such taxable year to the extent the allocations are attributable to income derived before the close of such year.

(2) *Patronage dividends, etc.* Patronage dividends, refunds, and rebates to patrons with respect to their patronage in the same or preceding years (whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount of such dividend, refund, or rebate) shall be taken into account in computing taxable income in the same manner as in the case of a cooperative organization not exempt under section 521. Such dividends, refunds, and rebates made after the close of the taxable year and on or before the 15th day of the 9th month following the close of such year shall be considered as made on the last day of such taxable year to the extent the dividends, refunds, or rebates, are attributable to patronage occurring before the close of such year.

§ 1.522–1 Tax treatment of farmers' cooperative marketing and purchasing associations exempt under section 521.

(a) *In general.* (1) Section 522 is applicable to farmers', fruit growers', or like associations organized and operated on a cooperative basis in the manner prescribed in section 521. Although such an association is subject to both normal tax and surtax, as in the case of corporations generally, certain special rules for the computation of taxable income are provided in section 522 (b) and § 1.522–2. For the purpose of any law which refers to organizations exempt from income taxes such an association shall, however, be considered as an organization exempt under section 501. Thus, the provisions of section 243, providing a credit for dividends received from a domestic corporation subject to taxation, are not applicable to dividends received from a cooperative association subject to section 522. The provisions of section 1501, relating to consolidated returns, are likewise not applicable.

(2) Rules governing the manner in which amounts allocated as patronage dividends, refunds, or rebates are to be taken into account in computing the taxable income of such an association are set forth in § 1.522–3. For the tax treatment, as to patrons, of amounts received during the taxable year as patronage dividends, rebates, or refunds, see section 61 and § 1.61–5.

(b) *Meaning of terms.* For purposes of §§ 1.522–1 to 1.522–3, inclusive, §§ 1.6044–1 and 1.61–5, the following terms shall have the meaning ascribed below:

(1) *Cooperative association.* The term "cooperative association" includes any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of the business done with or for such patrons, except that the term does not include any cooperative or nonprofit corporation (including any cooperative or nonprofit corporation engaged in rural electrification) exempt from taxation under section 501 (a) and described in section 501 (c) (12) or (15) or any corporation subject to a tax imposed by subchapter L, chapter 1 of the Code (relating to insurance companies).

(2) *Patron.* The term "patron" includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association.

(3) *Allocation.* The term "allocation" includes distributions made by a cooperative association to a patron in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, similar documents, or in any other manner whereby there is disclosed to a patron the dollar amount apportioned on the books of the association for the account of such patron. Thus, a mere credit to the account of a patron on the books of the cooperative association, without disclosure to the patron, is not an allocation.

(4) *Patronage dividends, rebates, and refunds.* The term "patronage dividend, rebate, or refund" includes any amount allocated by a cooperative association, to the account of a patron on the basis of the business done with or for such patron. The following are not patronage dividends, rebates, or refunds:

(i) Amounts distributed in redemption of capital stock, or in redemption or satisfaction of certificates of indebtedness, revolving fund certificates, retain certificates, letters of advice, or other similar documents;

(ii) Amounts allocated (whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the amount of such dividend, refund, or rebate) by the association for products of members or other patrons to the extent such amounts are fixed without reference to the earnings of the cooperative association. For this purpose, the term "earnings" includes the excess of amounts retained (or assessed) by the association to cover expenses or other items over the amount of such expenses or other items.

(c) *Examples.* The application of paragraph (b) of this section may be illustrated by the following examples:

Example (1). Cooperative A, a marketing association operating on a pooling basis, receives the products of patron W on January 5, 1954. On the same day Cooperative A advances to W 45 cents per unit for the products so delivered and allocates to him a "retain certificate" having a face value calculated at the rate of 5 cents per unit. During the operation of the pool, and before substantially all the products in the pool are disposed of, Cooperative A advances to W an additional 40 cents per unit, the amount being determined by reference to the market price of the products sold and the anticipated price of the unsold products. At the close of the pool on November 10, 1954, Cooperative A determines the excess of its receipts over the sum of its expenses and

its previous advances to patrons, and allo- over its costs and expenses, allocates to

its previous advances to patrons, and allocates to W an additional 3 cents per unit and shares of the capital stock of A having an aggregate of face value calculated at the rate of 2 cents per unit.

The amount of patronage dividends, rebates, or refunds allocated to W during 1954 amount to 5 cents per unit, consisting of the aggregate of the following per-unit allocations: The amount of cash distribution (3 cents), and the face value of the capital stock of A (2 cents), which are fixed with reference to the earnings of A. The amount of the two distributions in cash (85 cents) and the face amount of the "retain certificate" (5 cents), which are fixed without reference to the earnings of A, do not constitute patronage dividends, rebates, or refunds.

Example (2). Cooperative B, a marketing association operating on a pooling basis, receives the products of patron X on March 5, 1954. On the same day Cooperative B pays to X $1.00 per unit for such products, this amount being determined by reference to the market price of the product when received, and issues to him a participation certificate having no face value but which entitles X on the close of the pool to the proceeds derived from the sale of his products less the previous payment of $1.00 and the expenses and other charges attributable to such products. On March 5, 1957, Cooperative B, having sold the products in the pool, having deducted the previous payments for such products, and having determined the expenses and other charges of the pool, redeems the participation certificate of X in cash for 10 cents per unit. The allocation made to X during 1957, amounting to 10 cents per unit, is a patronage dividend, rebate, or refund. Neither the payment to X in 1954 of $1.00 nor the issuance to him of the participation certificate in that year constitutes a patronage dividend, rebate, or refund within the meaning of this section.

Example (3). Cooperative C, a purchasing association, obtains supplies for patron Y on May 1, 1954, and receives in return therefor $100. On February 1, 1955, Cooperative C, having determined the excess of its receipts over its costs and expenses, allocates to Y a cash distribution of $1.00 and a revolving fund certificate of a face amount of $1.00. The amount of patronage dividends, rebates, or refunds allocated to Y for 1955 is $2.00, the aggregate of the cash distribution of $1.00, and the face amount, $1.00, of the revolving fund certificate.

Example (4). Cooperative D, a service association, sells the products of members on a fee basis. It receives the products of patron Z under an agreement not to pool his products with those of other members, to sell his products, and to deliver to him the proceeds of the sale. Patron Z makes payments to Cooperative D during 1954 aggregating $75 for service rendered him by Cooperative D during that year. On May 15, 1955, Cooperative D, having determined the excess of its receipts over its costs and expenses, allocates to Z a cash distribution of $2.00. Such amount is a patronage dividend, rebate, or refund allocated by Cooperative D during 1955.

(d) *Returns of exempt cooperative associations.* For requirements of annual returns by exempt cooperative associations, see sections 6012 and 6072 (d) and paragraph (f) of § 1.6012–2.

§ 1.522–2 Manner of taxation of cooperative associations subject to section 522.

(a) *In general.* Farmers', fruit growers', or like associations, organized and operated in compliance with the requirements of section 521 and § 1.521–1 shall be subject to the taxes imposed by section 11 or section 1201, except that there shall be allowed as deductions from gross income, in addition to the other deductions allowable under chapter 1 of the Code, certain special deductions provided in section 522(b)(1)(A) and paragraph (c) of this section, and section 522 (b)(1)(B) and paragraph (d) of this section. Amounts allocated as patronage dividends, refunds, or rebates, whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated, with respect to patronage for the taxable year or for preceding taxable years, shall be taken into account in the manner provided in section 522 and in § 1.522–3.

(b) *Cooperative association exempt from tax before January 1, 1952.* (1) For the purpose of determining the method of accounting under section 446 in the case of a cooperative association which was exempt from tax for taxable years beginning prior to January 1, 1952, the method of accounting, recognized under sections 41, 42, and 43 of the Internal Revenue Code of 1939 and the regulations prescribed thereunder and utilized in the return of such association for its last taxable year to which the Internal Revenue Code of 1939 was applicable, shall be deemed to constitute the method of accounting regularly employed by the cooperative association. Any change from this method may be made only if permission is obtained from the Commissioner to change to another recognized method in accordance with section 446 and the regulations thereunder.

(2) In any case where inventories are an income-producing factor, see sections 471 and 472 and the regulations thereunder. The elective method of inventorying goods provided in section 472 may be adopted by the cooperative association for any taxable year beginning after December 31, 1953, in accordance with the requirements of section 472 and the regulations thereunder. However, in order to use such method for such a taxable year the cooperative association (unless it has used such method for a taxable year beginning after 1951 and before 1954 pursuant to an election exercised as provided in 26 CFR (1939) 39.22 (d)–3 (Regulations 118) must exercise the election provided in section 472 and the regulations thereunder, even if it may have utilized such method for accounting purposes for taxable years beginning before January 1, 1952.

(3) The following rules shall be applicable in computing the net operating loss deduction provided in section 172: No net operating loss carryover shall be allowed from a taxable year beginning prior to January 1, 1952, for which the cooperative association was exempt from tax under section 101(12) of the Internal Revenue Code of 1939. In the case of a taxable year beginning prior to January 1, 1952, for which the association was not exempt under section 101(12) of the Internal Revenue Code of 1939 and of any taxable year beginning after December 31, 1951, the amount of the net operating loss carryback or carryover from such year shall not be reduced by reference to the income of any taxable year beginning prior to January 1, 1952, for which the association was exempt from tax under section 101(12) of the Internal Revenue Code of 1939. However, any taxable year beginning prior to January 1, 1952, for which the cooperative association was exempt under section 101 (12) of the Internal Revenue Code of 1939 shall be taken into account in determining the period for which a net operating loss may be carried back or carried over, as the case may be.

(4) The adjustments to the cost or other basis provided in sections 1011 and 1016 and the regulations thereunder, are applicable for the entire period since the acquisition of the property. Thus, proper adjustment to basis must be made under section 1016 for depreciation, obsolescence, amortization, and depletion for all taxable years beginning prior to January 1, 1952, although the cooperative association was exempt from tax under section 521 or corresponding provisions of prior law for such years. However, no adjustment for percentage or discovery depletion is to be made for any year during which the association was exempt from tax. If a cooperative association has made a proper election in accordance with section 1020 and the regulations prescribed thereunder with respect to a taxable year beginning before 1952 in which the association was not exempt from tax, the adjustment to basis for depreciation for such years shall be limited in accordance with the provisions of section 1016 (a) (2).

(5) In the case of tax exempt and partially taxable bonds purchased at a premium and subject to amortization under section 171, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond. (For principles governing the method of computation, see the example in paragraph (b) of § 1.1016–9, relating to mutual savings banks, building and loan associations, and cooperative banks.) The basis of a fully taxable bond purchased at a premium shall be adjusted from the date of the election to amortize such premium in accordance with the provisions of section 171 except that no adjustment shall be allowable for such portion of the premium attributable to the period prior to the election.

(6) In the case of a mortgage acquired at a premium where the principal of such mortgage is payable in installments, adjustments to the basis for the premium must be made for all taxable years (whether or not the association was exempt from tax under section 521 during such years) in which installment payments are received. Such adjustments may be made on an individual mortgage basis or on a composite basis by reference to the average period of payments of the mortgage loans of such association. For the purpose of this adjustment, the term "premium" includes the excess of the acquisition value of the mortgage over its maturity value. The acquisition value of the mortgage is the cost including buying commissions, attorneys' fees or brokerage fees, but such value does not include amounts paid for accrued interest.

(c) *Deduction for dividends paid.* There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and § 1.521–1, amounts paid as dividends during the taxable year upon the capital stock of the cooperative association. For the purpose of the preceding sentence, the term "capital stock" includes common stock (whether voting or nonvoting), preferred stock, or any other form of capital represented by capital retain certificates, revolving fund certificates, letters of advice, or other evidence of a proprietary interest in a cooperative association. Such deduction is applicable only to the taxable year in which the dividends are actually or constructively paid to the holder of capital stock or other proprietary interest of the cooperative association. If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mail, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by such holder within the taxable year, a presumption arises that the dividend was paid to such holder in such year. The determination of whether a dividend has been paid to such holder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books. For further rules as to the determination of the right to a deduction for dividends paid, under certain specific circumstances, see section 561 and the regulations thereunder.

(d) *Deduction for amounts allocated from income not derived from patronage.* There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and § 1.521–1 amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether such amounts are paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. For this purpose, allocations made after the close of the taxable year and on or before the 15th day of the ninth month following the close of the taxable year shall be considered as made on the last day of such taxable year to the extent that such allocations are attributable to income derived during the taxable year or during years prior to the taxable year. As used in this paragraph, the term "income not derived from patronage" means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, from the sale or exchange of capital assets, constitutes income not derived from patronage. Business done with the United States shall constitute income not derived from patronage. In order that the deduction for income not derived from patronage may be applicable, it is necessary that the amount sought to be deducted be allocated on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. Thus, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during the taxable year, income realized from such gains must be allocated to patrons of such year in proportion to the amount of business done by such patrons during the taxable year. Similarly, if capital gains are realized by the association from the sale or exchange of capital assets held for a period of more than one taxable year income realized from such gains must be allocated, in proportion insofar as is practicable, to the patrons of the taxable years during which the asset was owned by the association, and to the amount of business done by such patrons during such taxable years.

§ 1.522–3 Patronage dividends, rebates, or refunds; treatment as to cooperative associations entitled to tax treatment under section 522.

(a) *General rule.* Patronage dividends, refunds, or rebates, allocated by a cooperative association entitled to tax treatment under section 522 to a patron shall be taken into account in computing the gross income of such association for the taxable year, as an increase in its other cost of goods sold in the case of an association marketing products for patrons, or as a reduction in its gross receipts, in the case of an association purchasing supplies and equipment or performing services for patrons, as the case may be, if:

(1) The allocation is made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated, and

(2) The allocation is made on or before the 15th day of the ninth month following the close of the taxable year in which the amounts allocated were received by the cooperative association.

For the purpose of subparagraph (1) of this paragraph, amounts allocated by a cooperative association entitled to tax treatment under section 522 will be deemed allocated in fulfillment and satisfaction of a valid enforceable obligation, if made pursuant to provisions of the by-laws, articles of incorporation, or other contract, whereby the association is obligated to make such allocation after the retention of "reasonable reserves" and after payment of dividends on capital stock or other proprietary capital interests. Notwithstanding the provisions of subparagraphs (1) and (2) of this paragraph, amounts allocated as patronage dividends, refunds, or rebates during the taxable year, on or before the 15th day of the ninth month following the close of such year, with respect to patronage for years preceding the taxable year, shall be taken into account as an increase in its other cost of goods sold, or as a reduction in gross receipts, for the taxable year, as the case may be, where retention as "reasonable reserves" of the amounts so allocated beyond the year in which earned was proper in accordance with the provisions of section 521 and where the allocation is made to the patron on a patronage basis in proportion insofar as is practicable, to the amount of business done by such patrons during the taxable year or years in which the retained amounts were received by the cooperative association.

(b) *Examples.* This section may be illustrated by the following examples:

Example (1). E, a cooperative association entitled to tax treatment under section 522, organized without capital stock, is engaged in the business of marketing products for its patrons on a non-pool basis. The by-laws of Cooperative E provide that there shall be allocated to patrons as patronage dividends within a reasonable time following the close of the year all of the gross returns from sales, less expenses of operation for the year and amounts retained as "reasonable reserves" necessary to the operation of Cooperative E. At the close of the taxable year, 1954, it is determined that from the gross returns from sales less operating expenses and all taxes for such year, $5,000 is to be retained as "reasonable reserves" for various necessary purposes of Cooperative E. It is assumed that the retention of such amount is proper in accordance with the provisions of section 521. Such $5,000 is apportioned on the books of Cooperative E to patrons of 1954 on a patronage basis, or permanent records are kept from which an apportionment to such patrons can be made. On March 1, 1955, pursuant to the terms of the by-laws, $200,000, the balance of the gross returns for the taxable year, is allocated to patrons of 1954 on the basis of patronage. $100,000 of such $200,000 is allocated in cash. The remaining $100,000 is allocated in "retain certificates", bearing no interest and redeemable in the discretion of the Board of Directors of Cooperative E. There may be added to the cost of goods sold by Cooperative E for 1954, $200,000 ($100,000 in cash, $100,000 in retain certificates), the total amount allocated as patronage dividends, rebates, or refunds in fulfillment and satisfaction of the obligation of the by-laws, on March 1, 1955, before the 15th day of the ninth month following the close of 1954. There may not be added to the cost of goods sold by Cooperative E for 1954, $5,000, the amount retained as reserves apportioned on the books, but not allocated as patronage dividends, rebates, or refunds.

Example (2). The facts are the same as example (1), it additionally appearing that at the close of 1955 it is determined by Cooperative E to allocate as cash patronage dividends, rebates, or refunds to patrons of 1954, $5,000, the amount retained as "reasonable reserves" for 1954 in accordance with the provisions of section 521. On March 1, 1956, such amount is allocated. There may be added to the cost of goods sold by Cooperative E for 1955, $5,000, the amount allocated with respect to patronage of a preceding year, 1954, properly maintained as a reserve under section 521.

SHIPOWNERS' PROTECTION AND INDEMNITY ASSOCIATIONS

§ 1.526 Statutory provisions; shipowners' protection and indemnity associations.

SEC. 526. *Shipowners' protection and indemnity associations.* There shall not be included in gross income the receipts of shipowners' mutual protection and indemnity associations not organized for profit, and no part of the net earnings of which

inures to the benefit of any private share-

inures to the benefit of any private shareholder; but such corporations shall be subject as other persons to the tax on their taxable income from interest, dividends, and rents.

CORPORATIONS USED TO AVOID INCOME TAX ON SHAREHOLDERS

CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS

§ 1.531 Statutory provisions; imposition of accumulated earnings tax.

SEC. 531. *Imposition of accumulated earnings tax.* In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

§ 1.531–1 Imposition of tax.

Section 531 imposes (in addition to the other taxes imposed upon corporations by chapter 1 of the Code) a graduated tax on the accumulated taxable income of every corporation described in section 532 and § 1.532–1. In the case of an affiliated group which makes, or is required to make, a consolidated return, see paragraph (a) of § 1.1502–30. All of the taxes on corporations under chapter 1 of the Code are treated as one tax for purposes of assessment, collection, payment, period of limitations, etc. See section 535 and §§ 1.535–1, 1.535–2, and 1.535–3 for the definition and determination of accumulated taxable income.

§ 1.532 Statutory provisions; corporations subject to accumulated earnings tax.

SEC. 532. *Corporations subject to accumulated earnings tax*—(a) *General rule.* The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

(b) *Exceptions.* The accumulated earnings tax imposed by section 531 shall not apply to—

(1) A personal holding company (as defined in section 542).

(2) A foreign personal holding company (as defined in section 552), or

(3) A corporation exempt from tax under subchapter F (section 501 and following).

§ 1.532–1 Corporations subject to accumulated earnings tax.

(a) *General rule.* (1) The tax imposed by section 531 applies to any domestic or foreign corporation (not specifically excepted under section 532(b) and paragraph (b) of this section) formed or availed of to avoid or prevent the imposition of the individual income tax on its shareholders, or on the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of dividing or distributing them. See section 533 and § 1.533–1, relating to evidence of purpose to avoid income tax with respect to shareholders.

(2) The tax imposed by section 531 may apply if the avoidance is accomplished through the formation or use of one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation, the earnings and profits of the M Corporation would not be returned as income subject to the individual income tax until such earnings and profits of the M Corporation were distributed to the N Corporation and distributed in turn by the N Corporation to its shareholders. If either the M Corporation or the N Corporation was formed or is availed of for the purpose of avoiding or preventing the imposition of the individual income tax upon the shareholders of the N Corporation, the accumulated taxable income of the corporation so formed or availed of (M or N, as the case may be) is subject to the tax imposed by section 531.

(b) *Exceptions.* The accumulated earnings tax imposed by section 531 does not apply to a personal holding company (as defined in section 542), to a foreign personal holding company (as defined in section 552), or to a corporation exempt from tax under subchapter F, chapter 1 of the Code.

(c) *Foreign corporations.* Section 531 is applicable to any foreign corporation, whether resident or nonresident, with respect to any income derived from sources, within the United States, if any of its shareholders are subject to income tax on the distributions of the corporation by reason of being (1) citizens or residents of the United States, or (2) nonresident alien individuals to whom section 871 is applicable, or (3) foreign corporations if a beneficial interest therein is owned directly or indirectly by any shareholder specified in subparagraph (1) or (2) of this paragraph.

§ 1.533 Statutory provisions; evidence of purpose to avoid income tax.

SEC. 533. *Evidence of purpose to avoid income tax*—(a) *Unreasonable accumulation determinative of purpose.* For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

(b) *Holding or investment company.* The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

§ 1.533–1 Evidence of purpose to avoid income tax.

(a) *In general.* (1) The Commissioner's determination that a corporation was formed or availed of for the purpose of avoiding income tax with respect to shareholders is subject to disproof by competent evidence. Section 533(a) provides that the fact that earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders unless the corporation, by the preponderance of the evidence, shall prove to the contrary. The burden of proving that earnings and profits have been permitted to accumulate beyond the reasonable needs of the business may be shifted to the Commissioner under section 534. See §§ 1.534–1 through 1.534–4. Section 533(b) provides that the fact that the taxpayer is a mere holding or investment company shall be prima facie evidence of the purpose to avoid income tax with respect to shareholders.

(2) The existence or nonexistence of the purpose to avoid income tax with respect to shareholders may be indicated by circumstances other than the conditions specified in section 533. Whether or not such purpose was present depends upon the particular circumstances of each case. All circumstances which might be construed as evidence of the purpose to avoid income tax with respect to shareholders cannot be outlined, but among other things, the following will be considered:

(i) Dealings between the corporation and its shareholders, such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders,

(ii) The investment by the corporation of undistributed earnings in assets having no reasonable connection with the business of the corporation (see § 1.537–3), and

(iii) The extent to which the corporation has distributed its earnings and profits.

The fact that a corporation is a mere holding or investment company or has an accumulation of earnings and profits in excess of the reasonable needs of the business is not absolutely conclusive against it if the taxpayer satisfies the Commissioner that the corporation was neither formed nor availed of for the purpose of avoiding income tax with respect to shareholders.

(b) *General burden of proof and statutory presumptions.* The Commissioner may determine that the taxpayer was formed or availed of to avoid income tax with respect to shareholders through the medium of permitting earnings and profits to accumulate. In the case of litigation involving any such determination (except where the burden of proof is on the Commissioner under section 534), the burden of proving such determination wrong by a preponderance of the evidence, together with the corresponding burden of first going forward with the evidence, is on the taxpayer under principles applicable to income tax cases generally. For the burden of proof in a proceeding before the Tax Court with respect to the allegation that earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, see section 534 and §§ 1.534–2 through 1.534–4. For a definition of a holding or investment company, see paragraph (c) of this section. For determination of the reasonable needs of the business, see section 537 and §§ 1.537–1 through 1.537–3. If the taxpayer is a mere holding or investment company, and the Commissioner therefore determines that the corporation was formed or availed of for the purpose of avoiding income tax with respect to shareholders,

then section 533 (b) gives further weight to the presumption of correctness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid income tax with respect to shareholders. Further, if it is established (after complying with section 534 where applicable) that earnings and profits were permitted to accumulate beyond the reasonable needs of the business and the Commissioner has therefore determined that the corporation was formed or availed of for the purpose of avoiding income tax with respect to shareholders, then section 533 (a) adds still more weight to the Commissioner's determination. Under such circumstances, the existence of such an accumulation is made determinative of the purpose to avoid income tax with respect to shareholders unless the taxpayer proves to the contrary by the preponderance of the evidence.

(c) *Holding or investment company.* A corporation having practically no activities except holding property and collecting the income therefrom or investing therein shall be considered a holding company within the meaning of section 533 (b). If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 533 (b).

(d) *Small business investment companies.* A corporation which is licensed to operate as a small business investment company under the Small Business Investment Act of 1958 (15 U.S.C. ch. 14B) and the regulations thereunder (13 CFR Part 107) will generally be considered to be a "mere holding or investment company" within the meaning of section 533(b). However, the presumption of the existence of the purpose to avoid income tax with respect to shareholders which results from the fact that such a company is a "mere holding or investment company" will be considered overcome so long as such company:

(1) Complies with all the provisions of the Small Business Investment Act of 1958 and the regulations thereunder; and

(2) Actively engages in the business of providing funds to small business concerns through the purchase of convertible debenture bonds of such concerns or through the disbursement of long-term loans to such concerns (see sections 304 and 305 of the Small Business Investment Act of 1958 (15 U.S.C. 684, 685)).

On the other hand, if such a company violates or fails to comply with any of the provisions of the Small Business Investment Act of 1958 or the regulations thereunder or ceases to invest its funds actively in small business concerns as provided in subparagraph (2) of this paragraph, it will not be considered to have overcome the presumption by reason of any rules provided in this paragraph.

§ 1.533–2 Statement required.

The corporation may be required to furnish a statement of its accumulated earnings and profits, the payment of dividends, the name and address of, and number of shares held by, each of its shareholders, the amounts that would be payable to each of the shareholders if the income of the corporation were distributed, and other information required under section 6042.

§ 1.534 Statutory provisions; burden of proof.

SEC. 534. *Burden of proof*—(a) *General rule.* In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

(1) If notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) If the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) *Notification by Secretary.* Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by certified mail or registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (e) (2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day.

(c) *Statement by taxpayer.* Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

(d) *Jeopardy assessment.* If pursuant to section 6861 (a) a jeopardy assessment is made before the mailing of the notice of deficiency referred to in subsection (a), for purposes of this section such notice of deficiency shall, to the extent that it informs the taxpayer that such deficiency includes the accumulated earnings tax imposed by section 531, constitute the notification described in subsection (b), and in that event the statement described in subsection (c) may be included in the taxpayer's petition to the Tax Court.

(e) *Application of section.* (1) Notwithstanding any other provision of law, this section shall apply with respect to taxable years to which this subchapter applies and (except as provided in paragraph (2)) to taxable years to which the corresponding provisions of prior revenue laws apply.

(2) In the case of a notice of deficiency for a taxable year to which this subchapter does not apply, this section shall apply only in the case of proceedings tried on the merits after [August 11, 1955] the date of the enactment of this paragraph.

[Sec. 534 as amended by secs. 4 and 5, Act of Aug. 11, 1955 (Pub. Law 367, 84th Cong., 69 Stat. 689); sec. 89(b), Technical Amendments Act 1958 (72 Stat. 1665)]

§ 1.534–1 Burden of proof as to unreasonable accumulations generally.

For purposes of applying the presumption provided for in section 533(a) and in determining the extent of the accumulated earnings credit under section 535 (c) (1), the burden of proof with respect to an allegation by the Commissioner that all or any part of the earnings and profits of the corporation have been permitted to accumulate beyond the reasonable needs of the business may vary under section 534 as between litigation in the Tax Court and that in any other court. In case of a proceeding in a court other than the Tax Court, see paragraph (b) of § 1.533–1.

§ 1.534–2 Burden of proof as to unreasonable accumulations in cases before the Tax Court.

(a) *Burden of proof on Commissioner.* Under the general rule provided in section 534(a), in any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation is upon the Commissioner if—

(1) A notification, as provided for in section 534 (b) and paragraph (c) of this section, has not been sent to the taxpayer; or

(2) A notification, as provided for in section 534 (b) and paragraph (c) of this section, has been sent to the taxpayer and, in response to such notification, the taxpayer has submitted a statement, as provided in section 534 (c) and paragraph (d) of this section, setting forth the ground or grounds (together with facts sufficient to show the basis thereof) on which it relies to establish that all or any part of its earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business. However, the burden of proof in the latter case is upon the Commissioner only with respect to the relevant ground or grounds set forth in the statement submitted by the taxpayer, and only if such ground or grounds are supported by facts (contained in the statement) sufficient to show the basis thereof.

(b) *Burden of proof on the taxpayer.* The burden of proof in a Tax Court proceeding with respect to an allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business is upon the taxpayer if—

(1) A notification, as provided for in section 534 (b) and paragraph (c) of this section, has been sent to the taxpayer and the taxpayer has not submitted a statement, in response to such notification, as provided in section 534 (c) and paragraph (d) of this section; or

(2) A statement has been submitted by the taxpayer in response to such notification, but the ground or grounds on which the taxpayer relies are not relevant to the allegation or, if relevant, the

statement does not contain facts suf-

statement does not contain facts sufficient to show the basis thereof.

(c) *Notification to the taxpayer.* Under section 534 (b) a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531 may be sent by registered mail (or by certified or registered mail, if the notification is mailed after September 2, 1958) to the taxpayer at any time before the mailing of the notice of deficiency in the case of a taxable year beginning after December 31, 1953, and ending after August 16, 1954. See § 1.534–4 for rules relating to taxable years subject to the Internal Revenue Code of 1939. See section 534 (d) and § 1.534–3 with respect to a notification in the case of a jeopardy assessment.

(d) *Statement by taxpayer.* (1) A taxpayer who has received a notification, as provided in section 534 (b) and paragraph (c) of this section, that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531, may, under section 534 (c), submit a statement that all or any part of the earnings and profits of the corporation have not been permitted to accumulate beyond the reasonable needs of the business. Such statement shall set forth the ground or grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that there has been no accumulation of earnings and profits beyond the reasonable needs of the business. See paragraphs (a) and (b) of this section for rules concerning the effect of the statement with respect to burden of proof. See §§ 1.537–1 to 1.537–3, inclusive, relating to reasonable needs of the business.

(2) The taxpayer's statement, under section 534 (c) and this paragraph, must be submitted to the Internal Revenue office which issued the notification (referred to in section 534 (b) and paragraph (c) of this section) within 60 days after the mailing of such notification. If the taxpayer is unable, for good cause, to submit the statement within such 60-day period, an additional period not exceeding 30 days may be granted upon receipt in the Internal Revenue office concerned (before the expiration of the 60-day period provided herein) of a request from the taxpayer, setting forth the reasons for such request. See section 534 (d) and § 1.534–3 with respect to a statement in the case of a jeopardy assessment.

§ 1.534–3 Jeopardy assessments in Tax Court cases.

In the case of a jeopardy assessment, a notice of deficiency is required to be sent to the taxpayer by registered mail (or by certified or registered mail, if the notice is mailed after September 2, 1958) within 60 days after the making of the assessment. See section 6861. If a jeopardy assessment is made before the mailing of the deficiency notice, then in the case of a proceeding in the Tax Court, if the deficiency notice informs the taxpayer that an amount of accumulated earnings tax is included in the deficiency, such notice shall constitute the notification provided for in section 534(b) and paragraph (c) of § 1.534–2. Under such circumstances the statement described in section 534(c) and paragraph (d) of § 1.534–2 shall instead be included in the taxpayer's petition to the Tax Court, if the taxpayer desires to submit such statement. See paragraph (b) of § 1.534–2, relating to burden of proof on the taxpayer.

§ 1.534–4 Taxable years subject to the Internal Revenue Code of 1939.

The rules prescribed in §§ 1.534–1 to 1.534–3, inclusive, apply in any proceeding tried on the merits after August 11, 1955, before the Tax Court and involving a notice of deficiency in surtax imposed by section 102 of the Internal Revenue Code of 1939, for a taxable year subject to such code, based in whole or in part on the allegation that all or any part of the earnings and profits of the taxpayer have been permitted to accumulate beyond the reasonable needs of the business. If a notice of deficiency for a taxable year described in the preceding sentence was mailed before September 11, 1955, a notification mailed before that date shall be effective as fully as though such notification had been mailed before the notice of deficiency was mailed.

§ 1.535 Statutory provisions; accumulated taxable income.

SEC. 535. *Accumulated taxable income*—(a) *Definition.* For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(b) *Adjustments to taxable income.* For purposes of subsection (a), taxable income shall be adjusted as follows:

(1) *Taxes.* There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164 (b) (6)), accrued during the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law.

(2) *Charitable contributions.* The deduction for charitable contributions provided under section 170 shall be allowed without regard to section 170(b)(2).

(3) *Special deductions disallowed.* The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) *Net operating loss.* The net operating loss deduction provided in section 172 shall not be allowed.

(5) *Capital losses.* There shall be allowed as deductions losses from sales or exchanges of capital assets during the taxable year which are disallowed as deductions under section 1211 (a).

(6) *Long-term capital gains.* There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryover provided in section 1212) minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) The taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) Such taxes computed for such year without including in taxable income the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined with regard to the capital loss carryover provided in section 1212).

(7) *Capital loss carryover.* No allowance shall be made for the capital loss carryover provided in section 1212.

(8) *Bank affiliates.* There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(c) *Accumulated earnings credit*—(1) *General rule.* For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b) (6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) *Minimum credit.* The credit allowable under paragraph (1) shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(3) *Holding and investment companies.* In the case of a corporation which is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(4) *Accumulated earnings and profits.* For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends which under section 563 (a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.

(5) *Cross reference.* For denial of credit provided in paragraph (2) or (3) where multiple corporations are formed to avoid tax, see section 1551.

[Sec. 535 as amended by sec. 31, Technical Amendments Act 1958 (72 Stat. 1631); sec. 205, Small Business Tax Revision Act 1958 (72 Stat. 1680)]

§ 1.535–1 Definition.

(a) The accumulated earnings tax is imposed by section 531 on the accumulated taxable income. Accumulated taxable income is the taxable income of the corporation with the adjustments prescribed by section 535(b) and § 1.535–2, minus the sum of the dividends paid deduction and the accumulated earnings credit. See paragraph (a)(18) of § 1.1502–31 for definition of consolidated accumulated taxable income. See section 561 and the regulations thereunder, relating to the definition of the deduction for dividends paid, and section

535(c) and § 1.535–3, relating to the accumulated earnings credit.

(b) In the case of a foreign corporation, whether resident or nonresident, which files or causes to be filed a return, the accumulated taxable income shall be the taxable income from sources within the United States with the adjustments prescribed by section 535 (b) and § 1.535–2 minus the sum of the dividends paid deduction and the accumulated earnings credit. In the case of a foreign corporation which files no return, the accumulated taxable income shall be the gross income from sources within the United States without allowance of any deductions (including the accumulated earnings credit).

§ 1.535–2 Adjustments to taxable income.

(a) *Taxes*—(1) *United States taxes.* In computing accumulated taxable income for any taxable year, there shall be allowed as a deduction the amount by which Federal income and excess profits taxes accrued during the taxable year exeeed the credit provided by section 33 (relating to taxes of foreign countries and possessions of the United States), except that no deduction shall be allowed for (i) the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), (ii) the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (iii) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939, for taxable years beginning after December 31, 1940. The deduction is for taxes accrued during the taxable year, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursements method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(2) *Taxes of foreign countries and United States possessions.* In computing accumulated taxable income for any taxable year, a deduction is allowed for income, war profits, and excess profits taxes accrued during such taxable year to foreign countries or possessions of the United States if the taxpayer chooses the benefits of section 901 for such taxable year. The credit for such taxes provided by section 901 is not allowed against the accumulated earnings tax imposed by section 531. See section 901 (a).

(b) *Charitable contributions.* Section 535 (b) (2) provides that, in computing the accumulated taxable income of a corporation, the deduction for charitable contributions shall be computed without regard to section 170(b) (2). Thus, the amount of charitable contributions made during the taxable year not allowable as a deduction under section 170 by reason of the limitations imposed by section 170(b)(2) shall be allowed as a deduction in computing accumulated taxable income for the taxable year. However, any excess of the amount of the charitable contributions made in a prior taxable year over the amount allowed as a deduction under section 170 for such year shall not be allowed as a deduction from taxable income in computing accumulated taxable income for the taxable year.

(c) *Special deductions disallowed.* Sections 241 through 248 provide for the allowance of special deductions for such items as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, and organizational expenses. Such special deductions, except the deduction provided by section 248 (relating to organizational expenses) shall be disallowed in computing accumulated taxable income.

(d) *Net operating loss.* The net operating loss deduction provided in section 172 is not allowed for purposes of computing accumulated taxable income.

(e) *Capital losses.* (1) Losses from sales or exchanges of capital assets during the taxable year, which are disallowed as deductions under section 1211 (a) in computing taxable income, shall be allowed as deductions in computing accumulated taxable income.

(2) The computation of the capital losses allowable as a deduction in computing accumulated taxable income may be illustrated by the following example:

Example. X Corporation has capital losses of $30,000 which are disallowed under section 1211 (a) for the taxable year ended December 31, 1956. This amount represents a loss of $25,000 from the sale or exchange of capital assets during the taxable year ended December 31, 1956, plus a $5,000 capital loss carryover resulting from the sale or exchange of capital assets during the taxable year ended December 31, 1955. In computing accumulated taxable income for the taxable year ended December 31, 1956, only the loss of $25,000 arising from the sale or exchange of capital assets during that taxable year will be allowed as a deduction.

(f) *Long-term capital gains.* (1) There is allowed as a deduction in computing accumulated taxable income, the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryover provided in section 1212) minus the taxes attributable to such excess as provided by section 535 (b) (6). The tax attributable to such excess is the difference between—

(i) The taxes (except the accumulated earnings tax) imposed by subtitle A of the Code for such year, and

(ii) The taxes (except the accumulated earnings tax) imposed by subtitle A computed for such year as if taxable income were reduced by the excess of the net long-term capital gain over net short-term capital loss (including the capital loss carryover to such year).

Where the tax (except the accumulated earnings tax) imposed by subtitle A includes an amount computed under section 1201 (a) (2), the tax attributable to such excess is such amount computed under section 1201 (a) (2).

(2) The application of the rule in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Assume that D. Corporation, for the taxable year ended December 31, 1956, has taxable income of $103,000 of which $3,000 is the excess of net long-term capital gain of $12,000 over a net short-term capital loss of $9,000. The $9,000 net short-term capital loss includes a capital loss carryover of $5,000. The amount allowable as a deduction under section 535 (b) (6) and subparagraph (1) of this paragraph is $7,250, computed as follows: Net long-term capital gain less net short-term capital loss (computed without regard to the capital loss carryover) is $8,000 (that is, $12,000 net long-term capital gain less $4,000 net short-term capital loss computed without regard to the capital loss carryover of $5,000). The tax attributable to the excess of net long-term capital gain over net short-term capital loss (computed by taking the capital loss carryover into account) is $750, that is, 25 percent of such excess of $3,000, computed under section 1201 (a) (2). The difference of $7,250 ($8,000 less $750) is the amount allowable as a deduction in computing accumulated taxable income.

(3) Section 631 (c) (relating to gain or loss in the case of disposal of coal) shall have no application in determining the amount of the deduction allowable under section 535 (b) (6).

(g) *Capital loss carryover.* The capital loss carryover provided in section 1212 is not allowed for purposes of computing accumulated taxable income.

(h) *Bank affiliates.* There is allowed the deduction provided by section 601 in the case of bank affiliates (as defined in section 2 of the Banking Act of 1933; 12 U. S. C. 221a (c)).

§ 1.535–3 Accumulated earnings credit.

(a) *In general.* As provided in section 535 (a) and § 1.535–1, the accumulated earnings credit, provided by section 535 (c), reduces taxable income in computing accumulated taxable income. In the case of a corporation, not a mere holding or investment company, the accumulated earnings credit is determined as provided in paragraph (b) of this section and, in the case of a holding or investment company, as provided in paragraph (c) of this section. See paragraph (a) (19) of § 1.1502–31 for the consolidated accumulated earnings credit.

(b) *Corporation which is not a mere holding or investment company*—(1) *General rule.* (i) In the case of a corporation, not a mere holding or investment company, the accumulated earnings credit is the amount equal to such part of the earnings and profits of the taxable year which is retained for the reasonable needs of the business, minus the deduction allowed by section 535 (b) (6) (see paragraph (f) of § 1.535–2, relating to the deduction for long-term capital gains). In no event shall the accumulated earnings credit be less than the minimum credit provided for in section 535 (c) (2) and subparagraph (2) of this paragraph. The amount of the earnings and profits for the taxable year retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction for such taxable year. See section 561 and §§ 1.561–1 and 1.561–2, relating to the deduction for dividends paid.

(ii) In determining whether any amount of the earnings and profits of the taxable year has been retained for the reasonable needs of the business, the accumulated earnings and profits of prior years will be taken into considera-

tion. Thus for example, if such ac-

tion. Thus, for example, if such accumulated earnings and profits of prior years are sufficient for the reasonable needs of the business, then any earnings and profits of the current taxable year which are retained will not be considered to be retained for the reasonable needs of the business. See section 537 and §§ 1.537–1 and 1.537–2.

(2) *Minimum credit.* Section 535 (c) (2) provides for the allowance of a minimum accumulated earnings credit in the case of a corporation which is not a mere holding or investment company. In the case of such a corporation, this minimum credit shall in no case be less than the amount by which $100,000 ($60,000 if the credit is computed for a taxable year beginning before January 1, 1958) exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. See paragraph (d) of this section for the effect of dividends paid after the close of the taxable year in determining accumulated earnings and profits at the close of the preceding taxable year. In determining the amount of the minimum credit allowable under section 535 (c) (2), the needs of the business are not taken into consideration. If the taxpayer has accumulated earnings and profits at the close of the preceding taxable year equal to or in excess of $100,000 ($60,000 if the credit is computed for a taxable year beginning before January 1, 1958), the credit, if any, is determined without regard to section 535(c)(2). It is not intended that the provision for the minimum credit shall in any way create an inference that an accumulation in excess of $100,000 ($60,000 if the credit is computed for a taxable year beginning before January 1, 1958) is unreasonable. The reasonable needs of the business may require the accumulation of more or less than $100,000 ($60,000 if the credit is computed for a taxable year beginning before January 1, 1958) depending upon the circumstances in the case, but such needs shall not be taken into consideration to any extent in cases where the minimum accumulated earnings credit is applicable. For a discussion of the reasonable needs of the business, see section 537 and §§ 1.537–1, 1.537–2, and 1.537–3.

(3) *Illustrations of accumulated earnings credit.* The computation of the accumulated earnings credit provided by section 535 (c) may be illustrated by the following examples:

Example (1). The X Corporation, which is not a mere holding or investment company, has accumulated earnings and profits in the amount of $75,000 as of December 31, 1955; it has earnings and profits for the taxable year ended December 31, 1956, in the amount of $100,000 and has a dividends paid deduction under section 561 in the amount of $30,000 so that the earnings and profits for the taxable year which are retained in the business amount to $70,000. Assume that it has been determined that the earnings and profits for the taxable year which may be retained for the reasonable needs of the business amount to $55,000 and that a deduction has been allowed under section 535 (b) (6) in the amount of $5,000. Since the earnings and profits at the close of the preceding taxable year, December 31, 1955, exceed $60,000, the minimum credit provided by section 535 (c) (2) will not apply and the accumulated earnings credit must be computed under section 535 (c) (1) on the basis of the reasonable needs of the business. In this case, the accumulated earnings credit for the taxable year ended December 31, 1956, will be $50,000, computed as follows:

Earnings and profits of the taxable year determined to be retained for the reasonable needs of the business	$55,000
Less: The deduction for long-term capital gains (less applicable tax) allowed under section 535 (b) (6)	5,000
Accumulated earnings credit allowable under section 535 (c) (1)	50,000

Example (2). The Z Corporation which is not a mere holding or investment company, has accumulated earnings and profits in the amount of $15,000 as of December 31, 1958; it has earnings and profits for the taxable year ended December 31, 1959, in the amount of $115,000 and has a dividends paid deduction under section 561 in the amount of $10,000, so that the earnings and profits for the taxable year which are retained amount to $105,000. Assume that it has been determined that the accumulated earnings and profits of the taxable year which may be retained for the reasonable needs of the business amount to $20,000 and that no deduction is allowable for long-term capital gains under section 535 (b) (6). The accumulated earnings credit allowable under section 535 (c) (1) on the basis of the reasonable needs of the business is determined to be only $20,000. However, since the amount by which $100,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year is more than $20,000, the minimum accumulated earnings credit provided by section 535(c) (2) is applicable. The allowable credit will be the amount by which $100,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year, i.e., $85,000 ($100,000 less $15,000 of accumulated earnings and profits at the close of the preceding taxable year).

(c) *Holding and investment companies.* Section 535 (c) (3) provides that, in the case of a mere holding or investment company, the accumulated earnings credit shall be the amount, if any, by which $100,000 ($60,000 if the credit is computed for a taxable year beginning before January 1, 1958) exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. Thus, if such a corporation has accumulated earnings equal to or in excess of, $100,000 ($60,000 if the credit is computed for a taxable year beginning before January 1, 1958) at the close of its preceding taxable year, no accumulated earnings credit is allowable in computing the accumulated taxable income. See paragraph (c) of § 1.533–1 for a definition of a holding or investment company.

(d) *Accumulated earnings and profits.* For the purposes of determining the minimum credit provided by section 535 (c) (2) and paragraph (b) (2) of this section, and the credit provided by section 535 (c) (3) and paragraph (c) of this section, dividends paid after the close of any taxable year which are considered paid during such taxable year, shall be deducted from the earnings and profits accumulated at the close of such taxable year. See section 563 and §§ 1.563–1 and 1.563–3, relating to dividends paid after the close of the taxable year.

§ 1.536 Statutory provisions; income not placed on annual basis.

SEC. 536. *Income not placed on annual basis.* Section 443 (b) (relating to computation of tax on change of annual accounting period) shall not apply in the computation of the accumulated earnings tax imposed by section 531.

§ 1.536–1 Short taxable years.

Accumulated taxable income for a taxable year consisting of a period of less than 12 months shall not be placed on an annual basis for the purpose of the accumulated earnings tax imposed by section 531. In such cases accumulated taxable income shall be computed on the basis of the taxable income for such period of less than 12 months, adjusted in the manner provided by section 535 (b) and § 1.535–2.

§ 1.537 Statutory provisions; reasonable needs of the business.

SEC. 537. *Reasonable needs of the business.* For purposes of this part, the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.

§ 1.537–1 Reasonable needs of the business.

(a) *In general.* The term "reasonable needs of the business" includes the reasonably anticipated needs of the business. An accumulation of the earnings and profits (including the undistributed earnings and profits of prior years) is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business. The need to retain earnings and profits must be directly connected with the needs of the corporation itself and must be for bona fide business purposes. See § 1.537–3 for a discussion of what constitutes the business of the corporation. The extent to which earnings and profits have been distributed by the corporation may be taken into account in determining whether or not retained earnings and profits exceed the reasonable needs of the business. See § 1.537–2, relating to grounds for accumulation of earnings and profits.

(b) *Reasonable anticipated needs.* (1) In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future needs of the business. Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of such

a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.

(2) Consideration shall be given to reasonably anticipated needs as they exist on the basis of the facts at the close of the taxable year. Thus, subsequent events shall not be used for the purpose of showing that the retention of earnings or profits was unreasonable at the close of the taxable year if all the elements of reasonable anticipation are present at the close of such taxable year. However, subsequent events may be considered to determine whether the taxpayer actually intended to consummate or has actually consummated the plans for which the earnings and profits were accumulated. In this connection, projected expansion or investment plans shall be reviewed in the light of the facts during each year and as they exist as of the close of the taxable year. If a corporation has justified an accumulation for future needs by plans never consummated, the amount of such an accumulation shall be taken into account in determining the reasonableness of subsequent accumulations.

§ 1.537–2 Grounds for accumulation of earnings and profits.

(a) *In general.* Whether a particular ground or grounds for the accumulation of earnings and profits indicate that the earnings and profits have been accumulated for the reasonable needs of the business or beyond such needs is dependent upon the particular circumstances of the case. Listed below in paragraphs (b) and (c) of this section are some of the grounds which may be used as guides under ordinary circumstances.

(b) *Reasonable accumulation of earnings and profits.* Although the following grounds are not exclusive, one or more of such grounds, if supported by sufficient facts, may indicate that the earnings and profits of a corporation are being accumulated for the reasonable needs of the business provided the general requirements under §§ 1.537–1 and 1.537–3 are satisfied:

(1) To provide for bona fide expansion of business or replacement of plant;

(2) To acquire a business enterprise through purchasing stock or assets;

(3) To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;

(4) To provide necessary working capital for the business, such as, for the procurement of inventories; or

(5) To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation.

(c) *Unreasonable accumulations of earnings and profits.* Although the following purposes are not exclusive, accumulations of earnings and profits to meet any one of such objectives may indicate that the earnings and profits of a corporation are being accumulated beyond the reasonable needs of the business:

(1) Loans to shareholders, or the expenditure of funds of the corporation for the personal benefit of the shareholders;

(2) Loans having no reasonable relation to the conduct of the business made to relatives or friends of shareholders, or to other persons;

(3) Loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder or shareholders are in control of both corporations;

(4) Investments in properties, or securities which are unrelated to the activities of the business of the taxpayer corporation; or

(5) Retention of earnings and profits to provide against unrealistic hazards.

§ 1.537–3 Business of the corporation.

(a) The business of a corporation is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake.

(b) If one corporation owns the stock of another corporation and, in effect, operates the other corporation, the business of the latter corporation may be considered in substance, although not in legal form, the business of the first corporation. However, investment by a corporation of its earnings and profits in stock and securities of another corporation is not, of itself, to be regarded as employment of the earnings and profits in its business. Earnings and profits of the first corporation put into the second corporation through the purchase of stock or securities or otherwise, may, if a subsidiary relationship is established, constitute employment of the earnings and profits in its own business. Thus, the business of one corporation may be regarded as including the business of another corporation if such other corporation is a mere instrumentality of the first corporation; that may be established by showing that the first corporation owns at least 80 percent of the voting stock of the second corporation. If the taxpayer's ownership of stock is less than 80 percent in the other corporation, the determination of whether the funds are employed in a business operated by the taxpayer will depend upon the particular circumstances of the case. Moreover, the business of one corporation does not include the business of another corporation if such other corporation is a personal holding company, an investment company, or a corporation not engaged in the active conduct of a trade or business.

PERSONAL HOLDING COMPANIES

§ 1.541 Statutory provisions; imposition of personal holding company tax.

SEC. 541. *Imposition of personal holding company tax.* In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to the sum of—

(1) 75 percent of the undistributed personal holding company income not in excess of $2,000, plus

(2) 85 percent of the undistributed personal holding company income in excess of $2,000.

§ 1.541–1 Imposition of tax.

(a) Section 541 imposes a graduated tax upon corporations classified as personal holding companies under section 542. This tax, if applicable, is in addition to the tax imposed upon corporations generally under section 11. Unless specifically excepted under section 542 (c) the tax applies to domestic and foreign corporations and, to the extent provided by section 542(b), to an affiliated group of corporations filing a consolidated return. Corporations classified as personal holding companies are exempt from the accumulated earnings tax imposed under section 531 but are not exempt from other income taxes imposed upon corporations, generally, under any other provisions of the Code. Unlike the accumulated earnings tax imposed under section 531, the personal holding company tax imposed by section 541 applies to all personal holding companies as defined in section 542; whether or not they were formed or availed of to avoid income tax upon shareholders. See section 6501(f) and § 301.6501(f)–1 of this chapter (Regulations on Procedure and Administration) with respect to the period of limitation on assessment of personal holding company tax upon failure to file a schedule of personal holding company income.

(b) A foreign corporation, whether resident or nonresident, which is classified as a personal holding company is subject to the tax imposed under section 541 with respect to its income from sources within the United States, even though such income is not fixed or determinable annual or periodical income specified in section 881. A foreign corporation is not classified as a personal holding company subject to tax under section 541 if it is a foreign personal holding company as defined in section 552 or if it meets the requirements of the exception provided in section 542 (c) (10).

§ 1.542 Statutory provisions; definition of personal holding company.

SEC. 542. *Definition of personal holding company*—(a) *General rule.* For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if—

(1) *Gross income requirement.* At least 80 percent of its gross income for the taxable year is personal holding company income as defined in section 543, and

(2) *Stock ownership requirement.* At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. For purposes of this paragraph, an organization described in section 503 (b) or a portion of a trust permanently set aside or to be used exclusively for the purposes described in section 642 (c) or a corresponding provision of a prior income tax law shall be considered an individual. The preceding sentence shall not apply in the case of an organization or trust organized or created before July 1, 1950, if at all times on or after July 1, 1950, and before the close of the taxable year such organization or trust has owned all of the common stock and at least 80 percent of the total number

of shares of all other classes of stock of the dividends received by a common parent

of shares of all other classes of stock of the corporation, but only if such organization or trust is not denied exemption under section 504 or an unlimited charitable deduction is not denied under section 681 (c) and, for this purpose—

(A) All income of the corporation which is available for distribution as dividends to its shareholders at the close of any taxable year shall be deemed to have been distributed at the close of such year whether or not any portion of such income was in fact distributed; and

(B) Section 504 (a) (1) and section 681 (c) (1) shall also not apply to income attributable to property of a decedent dying before January 1, 1951, which was transferred during his lifetime to a trust or property that was transferred under his will to such trust.

(b) *Corporations filing consolidated returns*—(1) *General rule.* In the case of an affiliated group of corporations filing or required to file a consolidated return under section 1501 for any taxable year, the gross income requirement of subsection (a) (1) of this section shall, except as provided in paragraphs (2) and (3), be applied for such year with respect to the consolidated gross income and the consolidated personal holding company income of the affiliated group. No member of such an affiliated group shall be considered to meet such gross income requirement unless the affiliated group meets such requirement.

(2) *Ineligible affiliated group.* Paragraph (1) shall not apply to an affiliated group of corporations, other than an affiliated group of railroad corporations the common parent of which would be eligible to file a consolidated return under section 141 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942, if—

(A) Any member of the affiliated group of corporations (including the common parent corporation) derived 10 percent or more of its gross income for the taxable year from sources outside the affiliated group, and

(B) 80 percent or more of the amount described in subparagraph (A) consists of personal holding company income (as defined in section 543).

For purposes of this paragraph, section 543 shall be applied as if the amount described in subparagraph (A) were the gross income of the corporation.

(3) *Excluded corporations.* Paragraph (1) shall not apply to an affiliated group of corporations if any member of the affiliated group (including the common parent corporation) is a corporation excluded from the definition of personal holding company under subsection (c).

(4) *Certain dividend income received by a common parent.* In applying paragraph (2) (A) and (B), personal holding company income and gross income shall not include dividends received by a common parent corporation from another corporation if—

(A) The common parent corporation owns, directly or indirectly, more than 50 percent of the outstanding voting stock of such other corporation, and

(B) Such other corporation is not a personal holding company for the taxable year in which the dividends are paid.

(c) *Exceptions.* The term "personal holding company" as defined in subsection (a) does not include—

(1) A corporation exempt from tax under subchapter F (sec. 501 and following);

(2) A bank as defined in section 581;

(3) A life insurance company;

(4) A surety company;

(5) A foreign personal holding company as defined in section 552;

(6) A licensed personal finance company under State supervision, 80 percent or more of the gross income of which is lawful interest received from loans made to individuals in accordance with the provisions of applicable State law if at least 60 percent of such gross income is lawful interest—

(A) Received from individuals each of whose indebtedness to such company did not at any time during the taxable year exceed in principal amount the limit prescribed for small loans by such law (or, if there is no such limit, $500), and

(B) Not payable in advance or compounded and computed only on unpaid balances, and if the loans to a person, who is a shareholder in such company during the taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by the members of his family as defined in section 544 (a) (2)), outstanding at any time during such year do not exceed $5,000 in principal amount;

(7) A lending company, not otherwise excepted by this subsection, authorized to engage in the small loan business under one or more State statutes providing for the direct regulation of such business, 80 percent or more of the gross income of which is lawful interest, discount or other authorized charges—

(A) Received from loans maturing in not more than 36 months made to individuals in accordance with the provisions of applicable State law, and

(B) Which do not, in the case of any individual loan, exceed in the aggregate an amount equal to simple interest at the rate of 3 percent per month not payable in advance and computed only on unpaid balances, if at least 60 percent of the gross income is lawful interest, discount or other authorized charges received from individuals each of whose indebtedness to such company did not at any time during the taxable year exceed in principal amount the limit prescribed for small loans by such law (or, if there is no such limit, $500), and if the deductions allowed to such company under section 162 (relating to trade or business expenses), other than for compensation for personal services rendered by shareholders (including members of the shareholder's family as described in section 544 (a) (2)) constitute 15 percent or more of its gross income, and the loans to a person, who is a shareholder in such company during the taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by the members of his family as defined in section 544 (a) (2)), outstanding at any time during such year do not exceed $5,000 in principal amount;

(8) A loan or investment corporation, a substantial part of the business of which consists of receiving funds not subject to check and evidenced by installment or fully paid certificates of indebtedness or investment, and making loans and discounts, and the loans to a person who is a shareholder in such corporation during such taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by the members of his family as defined in section 544 (a) (2)) outstanding at any time during such year do not exceed $5,000 in principal amount;

(9) A finance company, actively and regularly engaged in the business of purchasing or discounting accounts or notes receivable or installment obligations, or making loans secured by any of the foregoing or by tangible personal property, at least 80 percent of the gross income of which is derived from such business in accordance with the provisions of applicable State law or does not constitute personal holding company income as defined in section 543, if 60 percent of the gross income is derived from one or more of the following classes of transactions—

(A) Purchasing or discounting accounts or notes receivable, or installment obligations evidenced or secured by contracts of conditional sale, chattel mortgages, or chattel lease agreements, arising out of the sale of goods or services in the course of the transferor's trade or business;

(B) Making loans, maturing in not more than 36 months, to, and for the business purposes of, persons engaged in trade or business, secured by—

(i) Accounts or notes receivable, or installment obligations, described in subparagraph (A);

(ii) Warehouse receipts, bills of lading, trust receipts, chattel mortgages, bailments, or factor's liens, covering or evidencing the borrower's inventories;

(iii) A chattel mortgage on property used in the borrower's trade or business;

except loans to any single borrower which for more than 90 days in the taxable year of the company exceed 15 percent of the average funds employed by the company during such taxable year;

(C) Making loans, in accordance with the provisions of applicable State law, secured by chattel mortgages on tangible personal property, the original amount of each of which is not less than the limit referred to in, or prescribed by, paragraph (6) (A), and the aggregate principal amount of which owing by any one borrower to the company at any time during the taxable year of the company does not exceed $5,000; and

(D) If 30 percent or more of the gross income of the company is derived from one or more of the classes of transactions described in subparagraphs (A), (B), and (C), purchasing, discounting, or lending upon the security of, installment obligations of individuals where the transferor or borrower acquired such obligations either in transactions of the classes described in subparagraphs (A) and (C) or as a result of loans made by such transferor or borrower in accordance with the provisions of subparagraphs (A) and (B) of paragraph (6) or of subparagraphs (A) and (B) of paragraph (7) of this subsection, if the funds so supplied at all times bear an agreed ratio to the unpaid balance of the assigned installment obligations, and documents evidencing such obligations are held by the company;

provided that the deductions allowable under section 162 (relating to trade or business expenses), other than compensation for personal services rendered by shareholders (including members of the shareholder's family as described in section 544 (a) (2)), constitute 15 percent or more of the gross income, and that loans to a person who is a shareholder in such company during such taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by members of his family as defined in section 544 (a) (2)), outstanding at any time during such year do not exceed $5,000 in principal amount;

(10) A foreign corporation if—

(A) Its gross income from sources within the United States for the period specified in section 861(a)(2)(B) is less than 50 percent of its total gross income from all sources, and

(B) All of its stock outstanding during the last half of the taxable year is owned by nonresident alien individuals, whether directly or indirectly through other foreign corporations;

(11) A small business investment company which is licensed by the Small Business Administration and operating under the Small Business Investment Act of 1958 and which is actively engaged in the business of providing funds to small business concerns

under that Act. This paragraph shall not apply if any shareholder of the small business investment company owns at any time during the taxable year directly or indirectly (including, in the case of an individual, ownership by the members of his family as defined in section 544(a)(2)) a 5 per centum or more proprietary interest in a small business concern to which funds are provided by the investment company or 5 per centum or more in value of the outstanding stock of such concern.

[Sec. 542 as amended by sec. 3, Act of Aug. 12, 1955 (Pub. Law 385, 84th Cong., 69 Stat. 718); sec. 3, Act of Sept. 23, 1959 (Pub. Law 86-376, 73 Stat. 700)]

§ 1.542-1 General rule.

A personal holding company is any corporation (other than one specifically excepted under section 542(c)) which, for the taxable year, meets—

(a) The gross income requirement specified in section 542 (a) (1) and § 1.542-2, and

(b) The stock ownership requirement specified in section 542 (a) (2) and § 1.542-3.

Both requirements must be satisfied with respect to each taxable year.

§ 1.542-2 Gross income requirement.

To meet the gross income requirement it is necessary that at least 80 percent of the total gross income of the corporation for the taxable year be personal holding company income as defined in section 543 and §§ 1.543-1 and 1.543-2. For the definition of "gross income" see section 61 and §§ 1.61-1 through 1.61-14. Under such provisions gross income is not necessarily synonymous with gross receipts. Further, in the case of transactions in stocks and securities and in commodities transactions, gross income for personal holding company tax purposes shall include only the excess of gains over losses from such transactions. See section 543 (b), paragraph (b) (5) and (6) of § 1.543-1 and § 1.543-2.

§ 1.542-3 Stock ownership requirement.

(a) *General rule.* To meet the stock ownership requirement, it is necessary that at some time during the last half of the taxable year more than 50 percent in value of the outstanding stock of the corporation be owned, directly or indirectly, by or for not more than 5 individuals. Any organization or trust to which subparagraph (1) of this paragraph applies shall be considered as one individual for purposes of this stock ownership requirement subject, however, to the exception in subparagraph (2) of this paragraph which is applicable only to taxable years beginning after December 31, 1954. Thus, if an organization or trust which is considered as an individual owns 51 percent in value of the outstanding stock of the corporation at any time during the last half of the taxable year, the stock ownership requirement will be met by ownership of the required percentage by one individual. See section 544 and §§ 1.544-1 through 1.544-7 for the determination of stock ownership.

(1) *An organization or trust considered as an individual.* Any of the following organizations or trusts shall be considered as an individual:

(i) An organization to which section 503 applies, namely, any organization described in section 501 (c) (3) (relating to charitable, etc., organizations) or section 401 (a) (relating to employees' pension trust, etc.) other than an organization excepted from the application of section 503 by paragraphs (1) to (5) of section 503 (b). Therefore, a religious organization (other than a trust) excepted under section 503 (b) (1) is not considered an individual for purposes of the stock ownership requirement of section 542 (a) (2).

(ii) A portion of a trust permanently set aside or to be used exclusively for the purposes described in section 642 (c), relating to amounts set aside for charitable purposes, or described in a corresponding provision of the prior income tax law (such as section 162 (a), Internal Revenue Code of 1939).

(2) *Exception.* For taxable years beginning after December 31, 1954, an organization or trust to which subparagraph (1) of this paragraph applies shall not be considered an individual if all of the following conditions are met:

(i) It was organized or created before July 1, 1950,

(ii) At all times on or after July 1, 1950, and before the close of the taxable year, it owned all of the common stock and at least 80 percent of the total number of shares of all other classes of stock of the corporation, and

(iii) For the taxable year it is not denied exemption under section 504 (a) or the unlimited charitable deduction under section 681 (c). In determining whether, for the purpose of section 542 (a) (2), exemption is not denied under section 504 (a) or the unlimited charitable deduction is not denied under section 681 (c) all the income of the corporation which is available for distribution as dividends to its shareholders shall be deemed to have been distributed at the close of the taxable year whether or not any portion of such income was in fact distributed. If the amounts described in section 504 (a) or section 681 (c), increased by the income of the corporation deemed distributed pursuant to the preceding sentence, would be sufficient to deny exemption or the unlimited charitable deduction, the organization or trust will be considered to be an individual for the purpose of section 542 (a) (2). For the purpose of this subdivision the restrictions in sections 504 (a) (1) and 681 (c) (1) against unreasonable accumulations will not apply to income attributable to property of a decedent dying before January 1, 1951, which was transferred during his lifetime to a trust or property that was transferred under his will to such trust.

(iv) This subparagraph is illustrated by the following example:

Example. The X Charitable Foundation (an organization described in section 501 (c) (3) to which section 503 is applicable) has owned all of the stock of the Y Corporation since Y's organization in 1949. Both X and Y are calendar-year corporations. At the end of the year 1955, X has accumulated $100,000 out of income and has actually paid out only $75,000 of this amount, leaving a balance of $25,000 on December 31, 1955. X was not denied an exemption under section 504(a) for the year 1955. Y, during the calendar year 1955, has $400,000 taxable income of which $200,000 is available for distribution as dividends at the end of the year. X will be considered to have accumulated out of income during the calendar year 1955 the amount of $225,000 for the purpose of determining whether it would have been denied an exemption under section 504 (a) (1). If X would have been denied an exemption under section 504 (a) (1) by reason of having been deemed to have accumulated $225,000, the stock ownership requirement of section 542(a) (2) and this section will have been satisfied. If Y Corporation also satisfies the gross income requirement of section 542(a) (1) and § 1.542-2 it will be a personal holding company.

(b) *Changes in stock outstanding.* It is necessary to consider any change in the stock outstanding during the last half of the taxable year, whether in the number of shares or classes of stock, or in the ownership thereof. Stock subscribed and paid for will be considered as stock outstanding, whether or not such stock is evidenced by issued certificates. Treasury stock shall not be considered as stock outstanding.

(c) *Value of stock outstanding.* The value of the stock outstanding shall be determined in the light of all the circumstances. The value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class.

(d) *Applicability of rules.* The rules stated in this section are equally applicable in determining the stock ownership requirement specified in section 543 (a) (5), relating to personal service contracts, and in section 543 (a) (6), relating to the use of corporation property by a shareholder. The stock ownership requirement specified in these sections relates, however, to the stock outstanding at any time during the entire taxable year and not merely during the last half thereof.

§ 1.542-4 Corporations filing consolidated returns.

(a) *General rule.* A consolidated return under section 1501 shall determine the application of the personal holding company tax to the group and to any member thereof on the basis of the consolidated gross income and consolidated personal holding company income of the group, as determined under the regulations prescribed pursuant to section 1502 (relating to consolidated returns); however, this rule shall not apply to either (1) an ineligible affiliated group as defined in section 542 (b) (2) and paragraph (b) of this section, or (2) an affiliated group of corporations a member of which is excluded from the definition of a personal holding company under section 542 (c) and paragraph (c) of this section. Thus, in the latter two

instances the gross income requirement provided in section 542 (a) (1) and § 1.542–2 shall apply to each individual member of the affiliated group of corporations.

(b) *Ineligible affiliated group.* (1) Except for certain affiliated railroad corporations, as provided in subparagraph (2) of this paragraph, an affiliated group of corporations is an ineligible affiliated group and therefore may not use its consolidated gross income and consolidated personal holding company income to determine the liability of the group or any member thereof for personal holding company tax (as provided in paragraph (a) of this section), if (i) any member of such group, including the common parent, derived gross income from sources outside the affiliated group for the taxable year in an amount equal to 10 percent or more of its gross income from all sources for that year and (ii) 80 percent or more of the gross income from sources outside the affiliated group consists of personal holding company income as defined in section 543 and §§ 1.543–1 and 1.543–2. For purposes of subdivision (i) of this subparagraph gross income shall not include certain dividend income received by a common parent from a corporation not a member of the affiliated group which qualifies under section 542 (b) (4) and paragraph (d) of this section. See particularly the examples contained in paragraph (d) (2) of this section. Intercorporate dividends received by members of the affiliated group (including the common parent) are to be included in the gross income from all sources for purposes of the test in subdivision (i) of this subparagraph. For purposes of subdivision (ii) of this subparagraph, section 543 and paragraph (a) of § 1.543–1 shall be applied as if the amount of gross income derived from sources outside the affiliated group by a corporation which is a member of such group is the gross income of such corporation.

(2) An affiliated group of railroad corporations shall not be considered to be an ineligible affiliated group, notwithstanding any other provisions of section 542 (b) (2) and this paragraph, if the common parent of such group would be eligible to file a consolidated return under section 141 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942 (56 Stat. 798).

(3) See section 562 (d) and § 1.562–3 for dividends paid deduction in the case of a distribution by a member of an ineligible affiliated group.

(4) The determination of whether an affiliated group of corporations is an ineligible group under section 542 (b) (2) and this paragraph, may be illustrated by the following examples:

Example (1). Corporations X, Y, and Z constitute an affiliated group of corporations which files a consolidated return for the calendar year 1954; Corporations Y and Z are wholly-owned subsidiaries of Corporation X and derive no gross income from sources outside the affiliated group; Corporation X, the common parent, has gross income in the amount of $250,000 for the taxable year 1954. $200,000 of such gross income consists of dividends received from Corporations Y and Z. The remaining $50,000 was derived from sources outside the affiliated group, $40,000 of which represents personal holding company income as defined in section 543. The $50,000 included in the gross income of Corporation X and derived from sources outside the affiliated group is more than 10 percent of X's gross income ($50,000/250,000) and the $40,000 which represents personal holding company income is 80 percent of $50,000 (the amount considered to be the gross income of Corporation X). Accordingly, Corporations X, Y, and Z would be an ineligible affiliated group and the gross income requirement under section 542 (a) (1) and § 1.542–2 would be applied to each corporation individually.

Example (2). If, in the above example, only $30,000 of the $50,000 derived from sources outside the affiliated group by Corporation X represented personal holding company income, this group of affiliated corporations would not be an ineligible affiliated group. Although the $50,000 representing the gross income of Corporation X from sources outside the affiliated group is more than 10 percent of its total gross income, the amount of $30,000 representing personal holding company income is not 80 percent or more of the amount considered to be gross income for the purpose of this test. Under section 542 (b) (2) and subparagraph (1) of this paragraph both the gross income and the personal holding company income requirements must be satisfied in determining that an affiliated group constitutes an ineligible group. Since both of these requirements have not been satisfied in this example this group of affiliated corporations would not be an ineligible group.

(c) *Excluded corporations.* The general rule for determining liability of an affiliated group under paragraph (a) of this section shall not apply if any member thereof is a corporation which is excluded, under section 542 (c), from the definition of a personal holding company.

(d) *Certain dividend income received by a common parent.* (1) Dividends received by the common parent of an affiliated group from a corporation which is not a member of the affiliated group shall not be included in gross income or personal holding company income, for the purpose of the test under section 542 (b) (2)—

(i) If such common parent owned, directly or indirectly, more than 50 percent of the outstanding voting stock of the dividend paying corporation at the time such common parent became entitled to the dividend, and

(ii) If the dividend paying corporation is not a personal holding company for the taxable year in which the dividends are paid.

Thus, if the tests in subdivisions (i) and (ii) of this subparagraph are met, the dividend income received by the common parent from such other corporation will not be considered gross income for purposes of the test in section 542 (b) (2) (A) (paragraph (b) of this section), that is, either to determine gross income from sources outside the affiliated group or to determine gross income from all sources.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). Corporation X is the common parent of Corporation Y and Corporation Z and together they constitute an affiliated group which files a consolidated return under section 1501. Corporation Y and Corporation Z derived no income from sources outside the affiliated group. Corporation X, the common parent, had gross income of $100,000 for the calendar year 1954 of which amount $20,000 represented a dividend received from Corporation W, and $4,000 represented interest from Corporation T. The remaining gross income of X, $76,000, was received from Corporations Y and Z. Corporation X, for its entire taxable year, owned 60 percent of the voting stock of Corporation W which was not a personal holding company for the calendar year 1954. For the purpose of the gross income and personal holding company income test under section 542 (b) (2) and paragraph (b) of this section, the $20,000 dividend received from Corporation W would not be included in the gross income or personal holding company income of Corporation X. The affiliated group would not be an ineligible group under section 542 (b) (2) because 10 percent or more of its gross income was not from sources outside the affiliated group as required by section 542 (b) (2) (A). Inasmuch as the $20,000 dividend from Corporation W is not included in the gross income of Corporation X for purposes of section 542 (b) (2) Corporation X only has $4,000 gross income from sources outside the affiliated group which is only 5 percent of its gross income from all sources, $80,000.

Example (2). If, in example (1), Corporation X owned 50 percent or less of the voting stock of Corporation W at the time X became entitled to the dividend, or if Corporation W had been a personal holding company for the taxable year in which the dividends were paid, the $20,000 dividends received by Corporation X would be included in gross income and personal holding company income of Corporation X for the purpose of the test under section 542 (b) (2) and paragraph (b) of this section. Thus, the affiliated group would be an ineligible affiliated group under section 542 (b) (2) because 24 percent of its gross income was from sources outside the affiliated group ($24,000/$100,000) and 100 percent of this $24,000 was personal holding company income.

§ 1.543 Statutory provisions; definition of personal holding company income.

SEC. 543. *Personal holding company income*—(a) *General rule.* For purposes of this subtitle, the term "personal holding company income" means the portion of the gross income which consists of:

(1) *Dividends, etc.* Dividends, interest, royalties (other than mineral, oil, or gas royalties), and annuities. This paragraph shall not apply to interest constituting rent as defined in paragraph (7) or to interest on amounts set aside in a reserve fund under section 511 or 607 of the Merchant Marine Act, 1936.

(2) *Stock and securities transactions.* Except in the case of regular dealers in stock or securities, gains from the sale or exchange of stock or securities.

(3) *Commodities transactions.* Gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. This paragraph shall not apply to gains by a producer, processor, merchant, or handler of the commodity which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others.

(4) *Estates and trusts.* Amounts includible in computing the taxable income of the corporation under part I of subchapter J (sec. 641 and following, relating to estates, trusts, and beneficiaries); and gains from the sale or other disposition of any interest in an estate or trust.

(5) *Personal service contracts.* (A) Amounts received under a contract under

which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(B) Amounts received from the sale or other disposition of such a contract.

This paragraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

(6) *Use of corporation property by shareholder.* Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property; whether such right is obtained directly from the corporation or by means of a sublease or other arrangement. This paragraph shall apply only to a corporation which has personal holding company income for the taxable year, computed without regard to this paragraph and paragraph (7), in excess of 10 percent of its gross income.

(7) *Rents.* Rents, unless constituting 50 percent or more of the gross income. For purposes of this paragraph, the term "rents" means compensation, however designated, for the use of, or right to use, property, and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation; but does not include amounts constituting personal holding company income under paragraph (6).

(8) *Mineral, oil, or gas royalties.* Mineral, oil, or gas royalties, unless—

(A) Such royalties constitute 50 percent or more of the gross income, and

(B) The deductions allowable under section 162 (relating to trade or business expenses) other than compensation for personal services rendered by the shareholders, constitute 15 percent or more of the gross income.

(b) *Limitation on gross income in certain transactions.* For purposes of this part—

(1) Gross income and personal holding company income determined with respect to transactions described in section 543 (a) (2) (relating to gains from stock and security transactions) shall include only the excess of gains over losses from such transactions, and

(2) Gross income and personal holding company income determined with respect to transactions described in section 543 (a) (3) (relating to gains from commodity transactions) shall include only the excess of gains over losses from such transactions.

(c) *Gross income of insurance companies other than life or mutual.* In the case of an insurance company other than life or mutual, the term "gross income" as used in this part means the gross income, as defined in section 832 (b) (1), increased by the amount of losses incurred, as defined in section 832 (b) (5), and the amount of expenses incurred, as defined in section 832 (b) (6), and decreased by the amount deductible under section 832 (c) (7) (relating to tax-free interest).

§ 1.543–1 Personal holding company income.

(a) *General rule.* The term "personal holding company income" means the portion of the gross income which consists of the classes of gross income described in paragraph (b) of this section. See section 543 (b) and § 1.543–2 for special limitations on gross income and personal holding company income in cases of gains from stocks', securities', and commodities' transactions.

(b) *Definitions*—(1) *Dividends.* The term "dividends" includes dividends as defined in section 316 and amounts required to be included in gross income under section 551 and §§ 1.551–1—1.551–2 (relating to foreign personal holding company income taxed to United States shareholders).

(2) *Interest.* The term "interest" means any amounts, includible in gross income, received for the use of money loaned. However, (i) interest which constitutes "rent" shall not be classified as interest but shall be classified as "rents" (see subparagraph (10) of this paragraph) and (ii) interest on amounts set aside in a reserve fund under section 511 or 607 of the Merchant Marine Act, 1936 (46 U. S. C. 1161 or 1177), shall not be included in personal holding company income.

(3) *Royalties (other than mineral, oil, or gas royalties).* The term "royalties" (other than mineral, oil, or gas royalties) includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property. It does not, however, include rents. For rules relating to rents see section 543 (a) (7) and subparagraph (10) of this paragraph. For rules relating to mineral, oil, or gas royalties, see section 543 (a) (8) and subparagraph (11) of this paragraph.

(4) *Annuities.* The term "annuities" includes annuities only to the extent includible in the computation of gross income. See section 72 and §§ 1.72–1—1.72–14 for rules relating to the inclusion of annuities in gross income.

(5) *Gains from the sale or exchange of stock or securities.* (i) Except in the case of regular dealers in stocks or securities as provided in subdivision (ii) of this subparagraph, gross income and personal holding company income include the amount by which the gains exceed the losses from the sale or exchange of stock or securities. See section 543 (b) (1) and § 1.543–2 for provisions relating to this limitation. For this purpose, there shall be taken into account all those gains includible in gross income (including gains from liquidating dividends and other distributions from capital) and all those losses deductible from gross income which are considered under chapter 1 of the Code to be gains or losses from the sale or exchange of stock or securities. The term "stock or securities" as used in section 543(a)(2) and this subparagraph includes shares or certificates of stock, stock rights or warrants, or interest in any corporation (including any joint stock company, insurance company, association, or other organization classified as a corporation by the Code, certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral property, or lease, collateral trust certificates, voting trust certificates, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange, obligations issued by or on behalf of a State, Territory, or political subdivision thereof.

(ii) In the case of "regular dealers in stock or securities" there shall not be included gains or losses derived from the sale or exchange of stock or securities made in the normal course of business. The term "regular dealer in stock or securities" means a corporation with an established place of business regularly engaged in the purchase of stock or securities and their resale to customers. However, such corporations shall not be considered as regular dealers with respect to stock or securities which are held for investment. See section 1236 and § 1.1236–1.

(6) *Gains from futures transactions in commodities.* Gross income and personal holding company income include the amount by which the gains exceed the losses from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. See § 1.543–2 for provisions relating to this limitation. In general, for the purpose of determining such excess, there are included all gains and losses on futures contracts which are speculative. However, for the purpose of determining such excess, there shall not be included gains or losses from cash transactions, or gains or losses by a producer, processor, merchant, or handler of the commodity, which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. See section 1233 and § 1.1233–1.

(7) *Estates and trusts.* Under section 543 (a) (4) personal holding company income includes amounts includible in computing the taxable income of the corporation under part I, subchapter J, chapter 1 of the Code (relating to estates, trusts, and beneficiaries); and any gain derived by the corporation from the sale or other disposition of any interest in an estate or trust.

(8) *Personal service contracts.* (i) Under section 543 (a) (5) amounts received under a contract under which the corporation is to furnish personal services, as well as amounts received from the sale or other disposition of such contract, shall be included as personal holding company income if—

(*a*) Some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(*b*) At any time during the taxable year 25 percent or more in value of the outstanding stock of the corporatfon is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services. For this purpose, the

taxable year and (*b*) the aggregate

value of the outstanding stock shall be determined in accordance with the rules set forth in § 1.542–3. It should be noted that the stock ownership requirement of section 543 (a) (5) and this subparagraph relates to the stock ownership at any time during the taxable year. For rules relating to the determination of stock ownership, see section 544 and §§ 1.544–1 through 1.544–7.

(ii) If the contract, in addition to requiring the performance of services by a 25-percent stockholder who is designated or who could be designated (as specified in section 543 (a) (5) and subdivision (i) of this subparagraph), requires the performance of services by other persons which are important and essential, then only that portion of the amount received under such contract which is attributable to the personal services of the 25-percent stockholder shall constitute personal holding company income. Incidental personal services of other persons employed by the corporation to facilitate the performance of the services by the 25-percent stockholder, however, shall not constitute important or essential services. Under section 482 gross income, deductions, credits, or allowances between or among organizations, trades, or businesses may be allocated if it is determined that allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

(iii) The application of section 543 (a) (5) and this subparagraph may be illustrated by the following examples:

Example (1). A, whose profession is that of an actor, owns all of the outstanding capital stock of the M Corporation. The M Corporation entered into a contract with A under which A was to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which A was to receive $10,000 a year from the M Corporation. The M Corporation entered into a contract with the O Corporation in which A was designated to perform personal services for the O Corporation in consideration of which the O Corporation was to pay the M Corporation $500,000 a year. The $500,000 received by the M Corporation from the O Corporation constitutes personal holding company income.

Example (2). Assume the same facts as in example (1), except that, in addition to A's contract with the M Corporation, B, whose profession is that of a dancer and C, whose profession is that of a singer, were also under contract to the M Corporation to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which they were each to receive $25,000 a year from the M Corporation. Neither B nor C were stockholders of the M Corporation. The contract entered into by the M Corporation with the O Corporation, in addition to designating that A was to perform personal services for the O Corporation, designated that B and C were also to perform personal services for the O Corporation. Although the O Corporation particularly desired the services of A for an entertainment program it planned, it also desired the services of B and C, who were prominent in their fields, to provide a good supporting cast for the program. The services of B and C required under the contract are determined to be important and essential; therefore, only that portion of the $500,000 received by the M Corporation which is attributable to the personal services of A constitutes personal holding company income. The same result would obtain although the dancer and the singer required by the contract were not designated by name but the contract gave the M Corporation discretion to select and provide the services of a singer and a dancer for the program and such services were provided.

Example (3). The N Corporation is engaged in engineering. Its entire outstanding capital stock is owned by four individuals. The N Corporation entered into a contract with the R Corporation to perform engineering services in consideration of which the R Corporation was to pay the N Corporation $50,000. The individual who was to perform the services was not designated (by name or by description) in the contract and no one but the N Corporation had the right to designate (by name or by description) such individual. The $50,000 received by the N Corporation from the R Corporation does not constitute personal holding company income.

(9) *Compensation for use of property.* Under section 543 (a) (6) amounts received as compensation for the use of, or right to use, property of the corporation shall be included as personal holding company income if, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned directly or indirectly, by or for an individual entitled to the use of the property. Thus, if a shareholder who meets the stock ownership requirements of section 543 (a) (6) and this subparagraph uses, or has the right to use a yacht, residence or other property owned by the corporation, the compensation to the corporation for such use, or right to use, the property constitutes personal holding company income. This is true even though the shareholder may acquire the use of, or the right to use, the property by means of a sublease or under any other arrangement involving parties other than the corporation and the shareholder. However, if the personal holding company income of the corporation (after excluding any such income described in section 543 (a) (6) and this subparagraph, relating to compensation for use of property, and after excluding any such income described in section 543 (a) (7) and subparagraph (10) of this paragraph, relating to rents) is not more than 10 percent of its gross income, compensation for the use of property shall not constitute personal holding company income. For the purpose of applying section 543 (a) (6) and this subparagraph, the value of the outstanding stock shall be determined in accordance with the rules set forth in § 1.542–3. It should be noted that the stock ownership requirement of section 543 (a) (6) and this subparagraph relates to the stock outstanding at any time during the entire taxable year. For rules relating to the determination of stock ownership, see section 544 and §§ 1.544–1 through 1.544–7.

(10) *Rents (including interest constituting rents).* Rents which are to be included as personal holding company income consist of compensation (however designated) for the use, or right to use, property of the corporation. The term "rents" does not include amounts includible in personal holding company income under section 543 (a) (6) and subparagraph (9) of this paragraph. The amounts considered as rents include charter fees, etc., for the use of, or the right to use, property, as well as interest on debts owed to the corporation (to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of the corporation's trade or business was sold or exchanged by the corporation). However, if the amount of the rents includible under section 543 (a) (7) and this subparagraph constitutes 50 percent or more of the gross income of the corporation, such rents shall not be considered to be personal holding company income.

(11) *Mineral, oil, or gas royalties.* (i) The income from mineral, oil, or gas royalties is to be included as personal holding company income, unless (*a*) the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year and (*b*) the aggregate amount of deductions allowable under section 162 (other than compensation for personal services rendered by the shareholders of the corporation) equals 15 percent or more of the gross income of the corporation for the taxable year.

(ii) The term "mineral, oil, or gas royalties" means all royalties, including production payments and overriding royalties, received from any interest in mineral, oil, or gas properties. The term "mineral" includes those minerals which are included within the meaning of the term "minerals" in the regulations under section 611.

(iii) The first sentence of subdivision (ii) of this subparagraph shall apply to overriding royalties received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid, and to mineral, oil, or gas production payments, only with respect to amounts received after September 30, 1958.

§ 1.543–2 Limitation on gross income and personal holding company income in transactions involving stocks, securities and commodities.

(a) Under section 543(b)(1) the gains which are to be included in gross income, and in personal holding company income with respect to transactions described in section 543(a)(2) and paragraph (b)(5) of § 1.543–1, shall be the net gains from the sale or exchange of stock or securities. If there is an excess of losses over gains from such transactions, such excess (or net loss) shall not be used to reduce gross income or personal holding company income for purposes of the personal holding company tax. Similarly, under section 543(b)(2) the gains which are to be included in gross income, and in personal holding company income with respect to transactions described in section 543 (a) (3) and paragraph (b) (6) of § 1.543–1, shall be the net gains from commodity transactions which reflect personal holding company income. Any excess of losses over gains from such transactions (resulting in a net loss) shall not be used to reduce gross income or personal holding company income. The capital loss carryover under section 1212 shall not be taken into account.

(b) The application of section 543 (b) may be illustrated by the following examples:

Example (1). The P Corporation, not a regular dealer in stocks and securities, received rentals of $250,000 for its property from a 25-percent shareholder, and also had gains of $50,000 during the taxable year from the sale of stocks and securities. It also had losses on the sale of stocks and securities in the amount of $30,000. Accordingly, P Corporation had gross income during the taxable year of $270,000 ($250,000 plus $20,000 net gain from the sales of stocks and securities). It had personal holding company income of $20,000. (The rentals of $250,000 would not be personal holding company income under section 543 (a) (6) since the personal holding company income of the corporation, $20,000 (after excluding any such income described in section 543 (a) (6)), is not more than 10 percent of its gross income.)

Example (2). The R Corporation, not a regular dealer in stocks or securities, realized total gains during the taxable year of $900,000 from commodity futures transactions and $200,000 from the sales of stocks and securities. It also sustained total losses of $1,000,000 on such commodity futures transactions, resulting in a net gain for the taxable year of $100,000. None of the commodity futures transactions are hedging or other types of futures transactions excluded from the application of section 543 (a) (3). No part of the loss on commodity futures transactions is to be taken into account in determining personal holding company income and gross income for personal holding company tax purposes for the taxable year. The full amount of the $200,000 in gains from the sales of stocks and securities is to be included in personal holding company income and in gross income for personal holding company tax purposes for the taxable year.

§ 1.544 Statutory provisions; rules for determining stock ownership.

SEC. 544. *Rules for determining stock ownership*—(a) *Constructive ownership.* For purposes of determining whether a corporation is a personal holding company, insofar as such determination is based on stock ownership under section 542 (a) (2), section 543 (a) (5), or section 543 (a) (6)—

(1) *Stock not owned by individual.* Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.

(2) *Family and partnership ownership.* An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For purposes of this paragraph, the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(3) *Options.* If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(4) *Application of family-partnership and option rules.* Paragraphs (2) and (3) shall be applied—

(A) For purposes of the stock ownership requirement provided in section 542 (a) (2), if, but only if, the effect is to make the corporation a personal holding company;

(B) For purposes of section 543 (a) (5) (relating to personal service contracts), or of section 543 (a) (6) (relating to the use of property by shareholders), if, but only if, the effect is to make the amounts therein referred to includible under such paragraph as personal holding company income.

(5) *Constructive ownership as actual ownership.* Stock constructively owned by a person by reason of the application of paragraph (1) or (3) shall, for purposes of applying paragraph (1) or (2), be treated as actually owned by such person; but stock constructively owned by an individual by reason of the application of paragraph (2) shall not be treated as owned by him for purposes of again applying such paragraph in order to make another the constructive owner of such stock.

(6) *Option rule in lieu of family and partnership rule.* If stock may be considered as owned by an individual under either paragraph (2) or (3) it shall be considered as owned by him under paragraph (3).

(b) *Convertible securities.* Outstanding securities convertible into stock (whether or not convertible during the taxable year) shall be considered as outstanding stock—

(1) For purposes of the stock ownership requirement provided in section 542 (a) (2), but only if the effect of the inclusion of all such securities is to make the corporation a personal holding company;

(2) For purposes of section 543 (a) (5) (relating to personal service contracts), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such paragraph as personal holding company income; and

(3) For purposes of section 543 (a) (6) (relating to the use of property by shareholders), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such paragraph as personal holding company income.

The requirement in paragraphs (1), (2), and (3) that all convertible securities must be included if any are to be included shall be subject to the exception that, where some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be included although the others are not included, but no convertible securities shall be included unless all outstanding securities having a prior conversion date are also included.

§ 1.544–1 Constructive ownership.

(a) Rules relating to the constructive ownership of stock are provided by section 544 for the purpose of determining whether the stock ownership requirements of the following sections are satisfied:

(1) Section 542 (a) (2), relating to ownership of stock by five or fewer individuals;

(2) Section 543 (a) (5), relating to personal holding company income derived from personal service contracts;

(3) Section 543 (a) (6), relating to personal holding company income derived from property used by shareholders.

(b) Section 544 provides four general rules with respect to constructive ownership. These rules are:

(1) Constructive ownership by reason of indirect ownership. See section 544 (a) (1) and § 1.544–2.

(2) Constructive ownership by reason of family and partnership ownership. See section 544 (a) (2), (4), (5), and (6) and §§ 1.544–3, 1.544–6, and 1.544–7.

(3) Constructive ownership by reason of ownership of options. See section 544 (a) (3), (4), (5), and (6), and §§ 1.544–4, 1.544–6, and 1.544–7.

(4) Constructive ownership by reason of ownership of convertible securities. See section 544 (b) and § 1.544–5.

Each of rules referred to in subparagraphs 2, 3, and 4 of this paragraph is applicable only if it has the effect of satisfying the stock ownership requirement of the section to which applicable; that is, when applied to section 542 (a) (2), its effect is to make the corporation a personal holding company, or when applied to section 543 (a) (5) or section 543 (a) (6), its effect is to make the amounts described in such provisions includible as personal holding company income.

(c) All forms and classes of stock, however denominated, which represent the interests of shareholders, members, or beneficiaries in the corporation shall be taken into consideration in applying the constructive ownership rules of section 544.

(d) For rules applicable in treating constructive ownership, determined by one application of section 544, as actual ownership for purposes of a second application of section 544, see section 544 (a) (5) and § 1.544–6.

§ 1.544–2 Constructive ownership by reason of indirect ownership.

The following example illustrates the application of section 544 (a) (1), relating to constructive ownership by reason of indirect ownership:

Example. A and B, two individuals, are the exclusive and equal beneficiaries of a trust or estate which owns the entire capital stock of the M Corporation. The M Corporation in turn owns the entire capital stock of the N Corporation. Under such circumstances the entire capital stock of both the M Corporation and the N Corporation shall be considered as being owned equally by A and B as the individuals owning the beneficial interest therein.

§ 1.544–3 Constructive ownership by reason of family and partnership ownership.

(a) The following example illustrates the application of section 544 (a) (2), relating to constructive ownership by reason of family and partnership ownership.

Example. The M Corporation at some time during the last half of the taxable year, had 1,800 shares of outstanding stock, 450 of which were held by various individuals having no relationship to one another and none of whom were partners, and the remaining 1,350 were held by 51 shareholders as follows:

Relationships	Shares	Shares	Shares	Shares	Shares
An individual	A 100	B 20	C 20	D 20	E 20
His father	AF 10	BF 10	CF 10	DF 10	EF 10
His wife	AW 10	BW 40	CW 40	DW 40	EW 40
His brother	AB 10	BB 10	CB 10	DB 10	EB 10
His son	AS 10	BS 40	CS 40	DS 40	ES 40
His daughter by former marriage (son's half-sister)	ASHS 10	BSHS 40	CSHS 40	DSHS 40	ESHS 40
His brother's wife	ABW 10	BBW 10	CBW 10	DBW 160	EBW 10
His wife's father	AWF 10	BWF 10	CWF 110	DWF 10	EWF 10
His wife's brother	AWB 10	BWB 10	CWB 10	DWB 10	EWB 10
His wife's brother's wife	AWBW 10	BWBW 10	CWBW 10	DWBW 10	EWBW 110
Individual's partner	AP 10				

By applying the statutory rule provided in section 544 (a) (2) five individuals own more than 50 percent of the outstanding stock as follows:

A (including AF, AW, AB, AS, ASHS, AP)	160
B (including BF, BW, BB, BS, BSHS)	160
CW (including C, CS, CWF, CWB)	220
DB (including D, DF, DBW)	200
EWB (including EW, EWF, EWBW)	170
Total, or more than 50 percent	910

Individual A represents the obvious case where the head of the family owns the bulk of the family stock and naturally is the head of the group. A's partner owns 10 shares of the stock. Individual B represents the case where he is still head of the group because of the ownership of stock by his immediate family. Individuals C and D represent cases where the individuals fall in groups headed in C's case by his wife and in D's case by his brother because of the preponderance of holdings on the part of relatives by marriage. Individual E represents the case where the preponderant holdings of others eliminate that individual from the group.

(b) For the restriction on the applicability of the family and partnership ownership rules of this section, see paragraph (b) of § 1.544–1. For rules relating to constructive ownership as actual ownership, see § 1.544–6.

§ 1.544–4 Options.

The shares of stock which may be acquired by reason of an option shall be considered to be constructively owned by the individual having the option to acquire such stock. For example: If C, an individual, on March 1, 1955, purchases an option, or otherwise comes into possession of an option, to acquire 100 shares of the capital stock of M Corporation, such 100 shares of stock shall be considered to be constructively owned by C as if C had actually acquired the stock on that date. If C has an option on an option (or one of a series of options) to acquire such stock, he shall also be considered to have constructive ownership of the stock which may be acquired by reason of the option (or the series of options). Under such circumstances, C shall be considered to have acquired constructive ownership of the stock on the date he acquired his option. For the restriction on the applicability of the rule of this section, see paragraph (b) of § 1.544–1.

§ 1.544–5 Convertible securities.

Under section 544(b) outstanding securities of a corporation such as bonds, debentures, or other corporate obligations, convertible into stock of the corporation (whether or not convertible during the taxable year) shall be considered as outstanding stock of the corporation. The consideration of convertible securities as outstanding stock is subject to the exception that, if some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be considered as outstanding stock although the others are not so considered, but no convertible securities shall be considered as outstanding stock unless all outstanding securities having a prior conversion date are also so considered. For example, if outstanding securities are convertible in 1954, 1955 and 1956, those convertible in 1954 can be properly considered as outstanding stock without so considering those convertible in 1955 or 1956, and those convertible in 1954 and 1955 can be properly considered as outstanding stock without so considering those convertible in 1956. However, the securities convertible in 1955 could not be properly considered as outstanding stock without so considering those convertible in 1954 and the securities convertible in 1956 could not be properly considered as outstanding stock without so considering those convertible in 1954 and 1955. For the restriction on the applicability of the rule of this section, see paragraph (b) of § 1.544–1.

§ 1.544–6 Constructive ownership as actual ownership.

(a) *General rules.* (1) Stock constructively owned by a person by reason of the application of the rule provided in section 544(a) (1), relating to stock not owned by an individual, shall be considered as actually owned by such person for the purpose of again applying such rule or of applying the family and partnership rule provided in section 544(a) (2), in order to make another person the constructive owner of such stock, and

(2) Stock constructively owned by a person by reason of the application of the option rule provided in section 544 (a) (3) shall be considered as actually owned by such person for the purpose of applying either the rule provided in section 544 (a) (1), relating to stock not owned by an individual, or the family and partnership rule provided in section 544 (a) (2) in order to make another person the constructive owner of such stock, but

(3) Stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 544 (a) (2) shall not be considered as actually owned by such individual for the purpose of again applying such rule in order to make another individual the constructive owner of such stock.

(b) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). A's wife, AW, owns all the stock of the M Corporation, which in turn owns all the stock of the O Corporation. The O Corporation in turn owns all the stock of the P Corporation. Under the rule provided in section 544 (a) (1), relating to stock not owned by an individual, the stock in the P Corporation owned by the O Corporation is considered to be owned constructively by the M Corporation, the sole shareholder of the O Corporation. Such constructive ownership of the stock of the M Corporation is considered as actual ownership for the purpose of again applying such rule in order to make AW, the sole shareholder of the M Corporation, the constructive owner of the stock of the P Corporation. Similarly, the constructive ownership of the stock by AW is considered as actual ownership for the purpose of applying the family and partnership rule provided in section 544 (a) (2) in order to make A the constructive owner of the stock of the P Corporation, if such application is necessary for any of the purposes set forth in paragraph (b) of § 1.544–1. But the stock thus constructively owned by A may not be considered as actual ownership for the purpose of again applying the family and partnership rule in order to make another member of A's family, for example, A's father, the constructive owner of the stock of the P Corporation.

Example (2). B, an individual, owns all the stock of the R Corporation which has an option to acquire all the stock of the S Corporation, owned by C, an individual, who is not related to B. Under the option rule provided in section 544 (a) (3) the R Corporation may be considered as owning constructively the stock of the S Corporation owned by C. Such constructive ownership of the stock by the R Corporation is considered as actual ownership for the purpose of applying the rule provided in section 544 (a) (1), relating to stock not owned by an individual, in order to make B, the sole shareholder of the R Corporation, the constructive owner of the stock of the S Corporation. The stock thus constructively owned by B by reason of the application of the rule provided in section 544 (a) (1) likewise is considered as actual ownership for the purpose, if necessary, of applying the family and partnership rule provided in section 544 (a) (2), in order to make another member of B's family, for example, B's wife, BW, the constructive owner of the stock of the S Corporation. However, the family and partnership rule could not again be applied so as to make still another individual the constructive owner of the stock of the S Corporation, that is, the stock constructively owned by BW could not be considered as actually owned by her in order to make BW's father the constructive owner of such stock by a second application of the family and partnership rule.

§ 1.544–7 Option rule in lieu of family and partnership rule.

(a) If, in determining the ownership of stock, such stock may be considered as constructively owned by an individual by an application of either the family and partnership rule (section 544(a) (2)) or the option rule (section 544(a) (3)), such stock shall be considered as owned constructively by the individual by reason of the application of the option rule.

(b) The application of this section may be illustrated by the following example:

Example. Two brothers, A and B, each own 10 percent of the stock of the M Corporation, and A's wife, AW, also owns 10 percent of the stock of such corporation. AW's husband, A, has an option to acquire the stock owned by her at any time. It becomes necessary, for one of the purposes stated in section 544 (a) (4), to determine the stock ownership of B in the M Corporation. If the family and partnership rule were the only rule that applied in the case, B would be considered, under that rule, as owning 20 percent of the stock of the M Corporation, namely, his own stock plus the stock owned by his brother. In that event, B could not be considered as owning the stock held by AW since (1) AW is not a member of B's family and (2) the constructive ownership of such stock by A through the application of the family and partnership rule in his case is not considered as actual ownership so as to make B the constructive owner by a second application of the same rule with respect to the ownership of the stock. However, there is more than the family and partnership rule involved in this example. As the holder of an option upon the stock, A may be considered the constructive owner of his wife's stock by the application of the option rule and without reference to the family relationship between A and AW. If A is considered as owning the stock of his wife by applica-

tion of the option rule, then such constructive ownership by A is regarded as actual ownership for the purpose of applying the family and partnership rule so as to make another member of A's family, for example, B, the constructive owner of the stock. Hence, since A may be considered as owning his wife's stock by applying either the family-partnership rule or the option rule, the provisions of section 544 (a) (6) apply and accordingly A must be considered the constructive owner of his wife's stock under the option rule rather than the family-partnership rule. B thus becomes the constructive owner of 30 percent of the stock of the M corporation, namely, his own 10 percent, A's 10 percent, and AW's 10 percent constructively owned by A as the holder of an option on the stock.

§ 1.545 Statutory provisions; undistributed personal holding company income.

SEC. 545. *Undistributed personal holding company income*—(a) *Definition.* For purposes of this part, the term "undistributed personal holding company income" means the taxable income of a personal holding company adjusted in the manner provided in subsection (b), minus the dividends paid deduction as defined in section 561.

(b) *Adjustments to taxable income.* For the purposes of subsection (a), the taxable income shall be adjusted as follows:

(1) *Taxes.* There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164 (b) (6)), accrued during the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law. A taxpayer which, for each taxable year in which it was subject to the tax imposed by section 500 of the Internal Revenue Code of 1939, deducted Federal income and excess profits taxes when paid for the purpose of computing subchapter A net income under such Code, shall deduct taxes under this paragraph when paid, unless the taxpayer elects, in its return for a taxable year ending after June 30, 1954, to deduct the taxes described in this paragraph when accrued. Such an election shall be irrevocable and shall apply to the taxable year for which the election is made and to all subsequent taxable years.

(2) *Charitable contributions.* The deduction for charitable contributions provided under section 170 shall be allowed, but in computing such deduction the limitations in section 170(b)(1) (A) and (B) shall apply, and section 170(b)(2) shall not apply. For purposes of this paragraph, the term "adjusted gross income" when used in section 170(b)(1) means the taxable income computed with the adjustments (other than the 5-percent limitation) provided in the first sentence of section 170(b)(2) and without deduction of the amount disallowed under paragraph (3) of this subsection.

(3) *Special deductions disallowed.* The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) *Net operating loss.* The net operating loss deduction provided in section 172 shall not be allowed, but there shall be allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year computed without the deductions provided in part VIII (except section 248) of subchapter B.

(5) *Long-term capital gains.* There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) The taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) Such taxes computed for such year without including such excess in taxable income.

(6) *Bank affiliates.* There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(7) *Payment of indebtedness incurred prior to January 1, 1934.* There shall be allowed as a deduction amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred before January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness.

(8) *Expenses and depreciation applicable to property of the taxpayer.* The aggregate of the deductions allowed under section 162 (relating to trade or business expenses) and section 167 (relating to depreciation), which are allocable to the operation and maintenance of property owned or operated by the corporation, shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established (under regulations prescribed by the Secretary or his delegate) to the satisfaction of the Secretary or his delegate—

(A) That the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

(B) That the property was held in the course of a business carried on bona fide for profit; and

(C) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(9) *Amount of a lien in favor of the United States.* There shall be allowed as a deduction the amount, not to exceed the taxable income of the taxpayer, of any lien in favor of the United States (notice of which has been filed as provided in section 6323 (a) (1), (2), or (3)) to which the taxpayer is subject at the close of the taxable year. The sum of the amounts deducted under this paragraph with respect to any lien shall, for the purposes of this section, be added to the taxable income of the taxpayer for the taxable year in which such lien is satisfied or released. Where an amount is added to the taxable income of a corporation by reason of the preceding sentence of this paragraph, the shareholders of the corporation may, pursuant to regulations prescribed by the Secretary or his delegate, elect to compute the income tax with respect to such dividends as are attributable to such amount as though they were received ratably over the period the lien was in effect.

[Sec. 545 as amended by sec. 32, Technical Amendments Act 1958 (72 Stat. 1631)]

§ 1.545–1 Definition.

(a) Undistributed personal holding company income is the amount which is subject to the personal holding company tax imposed under section 541. Undistributed personal holding company income is the taxable income of the corporation adjusted in the manner described in section 545(b) and § 1.545–2, less the deduction for dividends paid. See part IV (section 561 and following), subchapter G, chapter 1 of the Code, and the regulations thereunder, relating to the dividends paid deduction.

(b) For purposes of the imposition of the personal holding company tax on a foreign corporation, resident or nonresident, which files or causes to be filed a return, the undistributed personal holding company income shall be computed on the basis of the taxable income from sources within the United States, and such income shall be adjusted in accordance with the principles of section 545 (b) and § 1.545–2. For purposes of the imposition of such tax on a foreign corporation, resident or nonresident, which files no return, the undistributed personal holding company income shall be computed on the basis of the gross income from sources within the United States without allowance of any deductions. For purposes of this paragraph, a nonresident foreign corporation will be considered to have filed a return for any taxable year ending before September 9, 1958, if the return for any such taxable year is filed on or before February 5, 1960.

§ 1.545–2 Adjustments to taxable income.

(a) *Taxes*—(1) *General rule.* (i) In computing undistributed personal holding company income for any taxable year, there shall be allowed as a deduction the amount by which Federal income and excess profits taxes accrued during the taxable year exceed the credit provided by section 33 (relating to taxes of foreign countries and possessions of the United States), and the income, war profits, and excess profits taxes of foreign countries and possessions of the United States accrued during the taxable year (to the extent provided by subparagraph (3) of this paragraph), except that no deduction shall be allowed for (*a*) the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), (*b*) the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (*c*) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939, for taxable years beginning after December 31, 1940. The deduction is for taxes for the taxable year, determined under the accrual method of accounting, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursement method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(ii) However, the taxpayer shall deduct taxes paid, rather than taxes accrued, if it used that method with respect to Federal taxes for each taxable year for which it was subject to the tax imposed by section 500 of the Internal Revenue Code of 1939, unless an election is made under subparagraph (2) of this paragraph to deduct taxes accrued.

(2) *Election by taxpayer which deducted taxes paid.* (i) If the corporation was subject to the personal holding company tax imposed by section 500 of the Internal Revenue Code of 1939 and, for the purpose of that tax, deducted Federal taxes paid rather than such

taxes accrued for each taxable year for

taxes accrued for each taxable year for which it was subject to such taxes, the corporation may elect for any taxable year ending after June 30, 1954, to deduct taxes accrued, including taxes of foreign countries and possessions of the United States, rather than taxes paid, for the purposes of the tax imposed by section 541 of the Internal Revenue Code of 1954. The election shall be made by deducting such taxes accrued on Schedule PH, Form 1120, to be filed with the return. The schedule shall, in addition, contain a statement that the corporation has made such election and shall set forth the year to which such election was first applicable. The deduction of taxes accrued in the year of election precludes the deduction of taxes paid during such year. The election, if made, shall be irrevocable and the deduction for taxes accrued shall be allowed for the year of election and for all subsequent taxable years.

(ii) Pursuant to section 7851 (a) (1) (C), the election provided for in subdivision (i) of this subparagraph may be made with respect to a taxable year ending after June 30, 1954, even though such taxable year is subject to the Internal Revenue Code of 1939.

(3) *Taxes of foreign countries and United States possessions.* In computing undistributed personal holding company income for any taxable year, a deduction is allowed for income, war profits and excess profits taxes accrued (or paid, if required under subparagraph (1) (ii) of this paragraph) during such taxable year to foreign countries or possessions of the United States if the taxpayer chooses the benefits of section 901 for such taxable year. The credit for such taxes provided by section 901 is not allowed against the personal holding company tax imposed by section 541. See section 901 (a).

(b) *Charitable contributions.* (1) Section 545(b)(2) provides that, in computing the deduction for charitable contributions for purposes of determining the undistributed personal holding company income of a corporation, the limitations in section 170(b)(1) (A) and (B) (relating to charitable contributions by individuals) shall apply and section 170 (b)(2) (relating to charitable contributions by corporations) shall not apply.

(2) Although the limitations of section 170(b)(1) (A) and (B) are 10 and 20 percent, respectively, of the individual's adjusted gross income, the limitations are applied for purposes of section 545 (b)(2) by using 10 and 20 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2) (that is, the same amount of taxable income to which the 5-percent limitation applied). Thus, the term "adjusted gross income" when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments (other than the 5-percent limitation) provided in the first sentence of section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 545(b) (8) (relating to expenses and depreciation applicable to property of the taxpayer). The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(2), shall not be allowed as a deduction in computing undistributed personal holding company income for any taxable year.

(3) See the regulations under section 170(b)(1) (A) and (B) with respect to the charitable contributions to which the 10-percent limitation is applicable and the charitable contributions to which the 20-percent limitation is applicable.

(c) *Special deductions disallowed.* Part VIII, subchapter B, chapter 1 of the Code, allows corporations, in computing taxable income, special deductions for such matters as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, organizational expenses, etc. See section 241. Such special deductions, except the deduction provided by section 248 (relating to organizational expenses) shall be disallowed in computing undistributed personal holding company income.

(d) *Net operating loss.* The net operating loss deduction provided in section 172 is not allowed for purposes of the computation of undistributed personal holding company income. For purposes of such a computation, however, there is allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year, except that, in computing undistributed personal holding company income for a taxable year beginning after December 31, 1957, the amount of such net operating loss shall be computed without the deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code.

(e) *Long-term capital gains.* (1) There is allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes attributable to such excess, as provided in section 545 (b) (5).

(2) Section 631 (c) (relating to gain or loss in the case of disposal of coal) shall have no application.

(f) *Bank affiliates.* There is allowed the deduction provided by section 601 in the case of bank affiliates (as defined in section 2 of the Banking Act of 1933; 12 U. S. C. 221a (c)).

(g) *Payment of indebtedness incurred prior to January 1, 1934*—(1) *General rule.* In computing undistributed personal holding company income, section 545 (b) (7) provides that there shall be allowed as a deduction amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred before January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness.

(2) *Indebtedness.* The term "indebtedness" means an obligation absolute and not contingent, to pay on demand or within a given time, in cash or other medium, a fixed amount. The term "indebtedness" does not include the obligation of a corporation on its capital stock. The indebtedness must have been incurred (or, if incurred by assumption, assumed) by the taxpayer before January 1, 1934. An indebtedness evidenced by bonds, notes, or other obligations issued by a corporation is ordinarily incurred as of the date such obligations are issued and the amount of such indebtedness is the amount represented by the face value of the obligations. In the case of refunding, renewal, or other change in the form of an indebtedness, the giving of a new promise to pay by the taxpayer will not have the effect of changing the date the indebtedness was incurred.

(3) *Amounts used or irrevocably set aside.* The deduction is allowable, in any taxable year, only for amounts used or irrevocably set aside in that year. The use or irrevocable setting aside must be to effect the extinguishment or discharge of indebtedness. In the case of refunding, renewal, or other change in the form of an indebtedness, the mere giving of a new promise to pay by the taxpayer will not result in an allowable deduction. If amounts are set aside in one year, no deduction is allowable for such amounts for a later year in which actually paid. As long as all other conditions are satisfied, the aggregate amount allowable as a deduction for any taxable year includes all amounts (from whatever source) used and all amounts (from whatever source) irrevocably set aside, irrespective of whether in cash or other medium. Double deductions shall not be allowed.

(4) *Reasonableness of the amounts with reference to the size and terms of the indebtedness.* (i) The reasonableness of the amounts used or irrevocably set aside must be determined by reference to the size and terms of the particular indebtedness. Hence, all the facts and circumstances with respect to the nature, scope, conditions, amount, maturity, and other terms of the particular indebtedness must be shown in each case.

(ii) Ordinarily an amount used to pay or retire an indebtedness, in whole or in part, at or prior to the maturity and in accordance with the terms thereof will be considered reasonable, and may be allowable as a deduction for the year in which so used. However, if an amount has been set aside in a prior year for payment or retirement of the same indebtedness, the amount so set aside shall not be allowed as a deduction in the year of the payment.

(iii) All amounts irrevocably set aside for the payment or retirement of an indebtedness in accordance with and pursuant to the terms of the obligation, for example, the annual contribution to trustees required by the provisions of a mandatory sinking fund agreement, will be considered as complying with the requirement of reasonableness. To be considered reasonable, it is not necessary that the plan of retirement provide for a retroactive setting aside of amounts for years prior to that in which the plan is adopted. However, if a voluntary plan was adopted before 1934, no adjustment is allowable in respect of the amounts set aside in the years prior to 1934.

(5) *Burden of proof.* The burden of proof will rest upon the taxpayer to sus-

tain the deduction claimed. Therefore, the taxpayer must furnish the information required by the return, and such other information as the district director may require in substantiation of the deduction claimed.

(6) *Allowance to a successor corporation.* For allowance of deduction for pre-1934 indebtedness to a successor corporation, see section 381 (c) (15).

(h) *Expenses and depreciation applicable to property of the taxpayer.* (1) In computing undistributed personal holding company income in the case of a personal holding company which owns or operates property, section 545 (b) (8) provides a specific limitation with respect to the allowance of deductions for trade or business expenses and depreciation allocable to the operation or maintenance of such property. Under this limitation, these deductions shall not be allowed in an amount in excess of the aggregate amount of the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner—

(i) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(ii) That the property was held in the course of a business carried on bona fide for profit; and

(iii) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(2) The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If, in computing undistributed personal holding company income, a personal holding company claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, it shall attach to its income tax return a statement setting forth its claim for allowance of the additional deductions, together with a complete statement of the facts and circumstances pertinent to its claim and the arguments on which it relies. Such statement shall set forth:

(i) A description of the property;

(ii) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(iii) The name and address of the person from whom the property was acquired and the date the property was acquired;

(iv) The name and address of the person to whom the property is leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(v) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;

(vi) Evidence that the rent or other compensation was the highest obtainable or, if none was received, a statement of the reasons therefor;

(vii) A copy of the contract, lease or rental agreement;

(viii) The purpose for which the property was used;

(ix) The business, carried on by the corporation, with respect to which the property was held and the gross income, expenses, and taxable income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(x) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(xi) Any other information pertinent to the taxpayer's claim.

(i) *Amount of a lien in favor of the United States.* (1) If notices of lien are filed in the manner provided in section 6323 (a) (1), (2), or (3), the amount of the liability to the United States outstanding at the close of the taxable year, and secured by such liens which are in effect at that time, shall be allowed as a deduction in computing undistributed personal holding company income. However, the amount of such deduction which may be allowed for any taxable year shall not exceed the taxable income (as adjusted for purposes of determining the undistributed personal holding company income, but without regard to the deduction under section 545 (b) (9)) for such year. The fact that the amount of, or any part of, the outstanding obligation to the United States was deducted for one taxable year does not prevent its deduction for a subsequent taxable year to the extent the obligation is still outstanding at the close of the subsequent taxable year and is secured by a lien, notice of which has been filed.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. If the taxpayer (on the calendar year basis) is subject to a lien (notice of which has been properly filed) in the amount of $500,000 at the close of the calendar year 1954 and has taxable income of $400,000 for such taxable year, the deduction allowable by reason of the lien for the calendar year 1954 is $400,000. If, at the close of the taxable year ended December 31, 1955, the taxpayer is still subject to the same lien of $500,000 and it has taxable income of $450,000, a deduction is allowed by reason of such lien in the amount of $450,000.

(3) When the obligation secured by the lien in favor of the United States has been satisfied or released, the sum of the amounts which have been allowed as deductions under section 545 (b) (9) in respect of such obligation shall be restored to taxable income for the year in which such lien is satisfied or released. If only a part of the obligation secured by the lien has been satisfied, the sum of the amounts which have been allowed as deductions under section 545 (b) (9) in respect of such part shall be included in taxable income for the year of the satisfaction for the purpose of determining undistributed personal holding company income. It should be noted, however, that only the sum of the amounts which have been allowed as deductions under section 545 (b) (9) and subparagraph (1) of this paragraph shall be included in taxable income. Thus, any amounts which were allowed as deductions under section 504 (e) of the Internal Revenue Code of 1939 shall not be included as taxable income for any taxable year under section 545 (b) (9) and subparagraph (1) of this paragraph.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example. Assume the same facts as in the example in subparagraph (2) of this paragraph, and assume further that the corporation has $100,000 taxable income both for 1956 (before including the $400,000 described below) and for 1957. In 1956, the corporation pays $200,000 of the obligation, thereby reducing its liability from $500,000 to $300,000. In such case, $400,000 is included in taxable income in computing its undistributed personal holding company income for 1956, that is, the sum of the $200,000 deduction for 1954 and the $200,000 deduction for 1955 in respect of the liability which is paid in 1956. In 1957, property of the corporation is discharged from the lien by reason of the fact that the value of the remaining property of the corporation exceeds double the outstanding liability. (See section 6325 (b) (1).) Since this was not a release or satisfaction of the lien, no amount is added to taxable income for 1957 with respect to the property discharged from the lien. In 1958, the remaining property is released from the lien by reason of a bond being accepted under section 6325 (a) (2). There is added to taxable income in computing undistributed personal holding company income for 1958, $850,000, that is, the sum of the deductions allowed for 1954, 1955, 1956, and 1957 in respect of the $300,000 liability, the lien for which was released in 1958. This amount of $850,000, is computed as follows:

Year	Outstanding liability	Taxable income	Deduction as limited by taxable income	Amount attributable to part payment of $200,000 in 1956	Amount attributable to release of lien in 1958
1954	$500,000	$400,000	$400,000	$200,000	$200,000
1955	500,000	450,000	450,000	200,000	250,000
1956	300,000	500,000	300,000		300,000
1957	300,000	100,000	100,000		100,000
Total					850,000

(5) (i) If an amount has been included in undistributed personal holding company income of the personal holding company by reason of section 545 (b) (9), any shareholder of the company may elect to compute his income tax with respect to such of his dividends as are attributable to such amount as though

such dividends were received ratably over the period the lien was in effect.

(ii) For purposes of section 545 (b) (9), the dividends paid during the taxable year of the personal holding company (computed as of the close of such year) shall be deemed attributable first to undistributed personal holding company income by reason of section 545 (b) (9) (computed as of the close of the taxable year of the personal holding company). If the period over which the lien was in effect consists of several taxable years of the personal holding company, the dividend deemed received for any taxable year shall be deemed received on the last day of such taxable year of the personal holding company.

(iii) Such election shall be made in a statement showing the amount of the deduction under section 545 (b) (9) for each taxable year of the period in which the lien was in effect, the amount of such deduction, if any, which was added to undistributed personal holding company income in a later year or years as a result of partial satisfaction or release of such lien, and the details thereof, the taxable year or years to which such dividends are allocable, and a computation of tax, on the basis of the election, for all taxable years affected by such ratable allocation of the dividends. Further, the statement shall show the district director's office in which the returns, for the years to which the dividends are allocable, were filed, the kind of returns which were filed (separate returns or joint returns), and the name and address under which the returns were filed. The statement shall be attached to the shareholder's return for the taxable year for which the dividend would be reported but for such election.

(iv) The operation of this subparagraph may be illustrated as follows: If, in the example under subparagraph (4) of this paragraph, shareholder A owns 75 percent in value of the outstanding stock of the personal holding company, and receives a dividend of $540,000 from such company during 1958 (the total dividend distribution being $720,000) he may elect to compute his income tax with respect to the $540,000 in dividends for 1958 as if he had received $127,058.82 of such dividends for 1954 ($200,000/850,000 of $540,000), $158,823.53 of such dividends for 1955 ($250,000/850,000 of $540,000), $190,588.23 of such dividends for 1956 ($300,000/850,000 of $540,000), and $63,529.41 of such dividends for 1957 ($100,000/850,000 of $540,000). Accordingly, the tax computed for 1958 with respect to such dividends shall be the aggregate of the taxes attributable to such amounts had they been distributed in the respective years.

§ 1.546 Statutory provisions; income not placed on annual basis.

SEC. 546. *Income not placed on annual basis.* Section 443 (b) (relating to computation of tax on change of annual accounting period) shall not apply in the computation of the personal holding company tax imposed by section 541.

§ 1.547 Statutory provisions; deduction for deficiency dividends.

SEC. 547. *Deduction for deficiency dividends*—(a) *General rule.* If a determination (as defined in subsection (c)) with respect to a taxpayer establishes liability for personal holding company tax imposed by section 541 (or by a corresponding provision of a prior income tax law) for any taxable year, a deduction shall be allowed to the taxpayer for the amount of deficiency dividends (as defined in subsection (d)) for the purpose of determining the personal holding company tax for such year, but not for the purpose of determining interest, additional amounts, or assessable penalties computed with respect to such personal holding company tax.

(b) *Rules for application of section*—(1) *Allowance of deduction.* The deficiency dividend deduction shall be allowed as of the date the claim for the deficiency dividend deduction is filed.

(2) *Credit or refund.* If the allowance of a deficiency dividend deduction results in an overpayment of personal holding company tax for any taxable year, credit or refund with respect to such overpayment shall be made as if on the date of the determination 2 years remained before the expiration of the period of limitation on the filing of claim for refund for the taxable year to which the overpayment relates. No interest shall be allowed on a credit or refund arising from the application of this section.

(c) *Determination.* For purposes of this section, the term "determination" means—

(1) A decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(2) A closing agreement made under section 7121; or

(3) Under regulations prescribed by the Secretary or his delegate, an agreement signed by the Secretary or his delegate and by, or on behalf of, the taxpayer relating to the liability of such taxpayer for personal holding company tax.

(d) *Deficiency dividends*—(1) *Definition.* For purposes of this section, the term "deficiency dividends" means the amount of the dividends paid by the corporation on or after the date of the determination and before filing claim under subsection (e), which would have been includible in the computation of the deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if distributed during such taxable year. No dividends shall be considered as deficiency dividends for purposes of subsection (a) unless distributed within 90 days after the determination.

(2) *Effect on dividends paid deduction*—(A) *For taxable year in which paid.* Deficiency dividends paid in any taxable year (to the extent of the portion thereof taken into account under subsection (a) in determining personal holding company tax) shall not be included in the amount of dividends paid for such year for purposes of computing the dividends paid deduction for such year and succeeding years.

(B) *For prior taxable year.* Deficiency dividends paid in any taxable year (to the extent of the portion thereof taken into account under subsection (a) in determining personal holding company tax) shall not be allowed for purposes of section 563 (b) in the computation of the dividends paid deduction for the taxable year preceding the taxable year in which paid.

(e) *Claim required.* No deficiency dividend deduction shall be allowed under subsection (a) unless (under regulations prescribed by the Secretary or his delegate) claim therefor is filed within 120 days after the determination.

(f) *Suspension of statute of limitations and stay of collection*—(1) *Suspension of running of statute.* If the corporation files a claim, as provided in subsection (e), the running of the statute of limitations provided in section 6501 on the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of the deficiency and all interest, additional amounts, or assessable penalties, shall be suspended for a period of 2 years after the date of the determination.

(2) *Stay of collection.* In the case of any deficiency with respect to the tax imposed by section 541 established by a determination under this section—

(A) The collection of the deficiency and all interest, additional amounts, and assessable penalties shall, except in cases of jeopardy, be stayed until the expiration of 120 days after the date of the determination, and

(B) If claim for deficiency dividend deduction is filed under subsection (e), the collection of such part of the deficiency as is not reduced by the deduction for deficiency dividends provided in subsection (a) shall be stayed until the date the claim is disallowed (in whole or in part), and if disallowed in part collection shall be made only with respect to the part disallowed.

No distraint or proceeding in court shall be begun for the collection of an amount the collection of which is stayed under subparagraph (A) or (B) during the period for which the collection of such amount is stayed.

(g) *Deduction denied in case of fraud, etc.* No deficiency dividend deduction shall be allowed under subsection (a) if the determination contains a finding that any part of the deficiency is due to fraud with intent to evade tax, or to wilful failure to file an income tax return within the time prescribed by law or prescribed by the Secretary or his delegate in pursuance of law.

(h) *Effective date.* Subsections (a) through (f), inclusive, shall apply only with respect to determinations made more than 90 days after the date of enactment of this title. If the taxable year with respect to which the deficiency is asserted began before January 1, 1954, the term "deficiency dividend" includes only amounts which would have been includible in the computation under the Internal Revenue Code of 1939 of the basic surtax credit for such taxable year. Subsection (g) shall apply only if the taxable year with respect to which the deficiency is asserted begins after December 31, 1953.

§ 1.547–1 General rule.

Section 547 provides a method under which, by virtue of dividend distributions, a corporation may be relieved from the payment of a deficiency in the personal holding company tax imposed by section 541 (or by a corresponding provision of a prior income tax law), or may be entitled to a credit or refund of a part or all of any such deficiency which has been paid. The method provided by section 547 is to allow an additional deduction for a dividend distribution (which meets the requirements of this section) in computing undistributed personal holding company income for the taxable year for which a deficiency in personal holding company tax is determined. The additional deduction for deficiency dividends will not, however, be allowed for the purpose of determining interest, additional amounts, or assessable penalties, computed with respect to the personal holding company tax prior to the allowance of the additional deduction for deficiency dividends. Such amounts remain payable as if section 547 had not been enacted.

§ 1.547–2 Requirements for deficiency dividends.

(a) *In general.* There are certain requirements which must be fulfilled before a deduction is allowed for a deficiency dividend under section 547 and this section. These are—

(1) The taxpayer's liability for personal holding company tax shall be determined only in the manner provided in section 547 (c) and paragraph (b) (1) of this section.

(2) The deficiency dividend shall be paid by the corporation on, or within 90 days after, the date of such determination and prior to the filing of a claim under section 547 (e) and paragraph (b) (2) of this section for deduction for deficiency dividends. This claim must be filed within 120 days after such determination.

(3) The deficiency dividend must be of such a nature as would have permitted its inclusion in the computation of a deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if it had been distributed during such year. See section 562 and §§ 1.562–1 through 1.562–3. In this connection, it should be noted that under section 316(b)(2), the term "dividend" means (in addition to the usual meaning under section 316(a)) any distribution of property (whether or not a dividend as defined in section 316 (a)) made by a corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 and §§ 1.545–1 and 1.545–2 without regard to section 316 (b) (2)) for the taxable year in respect of which the distribution is made.

(b) *Special rules*—(1) *Nature and details of determination.* (i) A determination of a taxpayer's liability for personal holding company tax shall, for the purposes of section 547, be established in the manner specified in section 547 (c) and this subparagraph.

(ii) The date of determination by a decision of the Tax Court of the United States is the date upon which such decision becomes final, as prescribed in section 7481.

(iii) The date upon which a judgment of a court becomes final, which is the date of the determination in such cases, must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

(iv) The date of determination by a closing agreement, made under section 7121, is the date such agreement is approved by the Commissioner.

(v) A determination under section 547 (c) (3) may be made by an agreement signed by the district director or such other official to whom authority to sign the agreement is delegated, and by or on behalf of the taxpayer. The agreement shall set forth the total amount of the liability for personal holding company tax for the taxable year or years. The date of the determination is the date such agreement is signed by the district director or such other official to whom authority to sign the agreement is delegated.

(2) *Claim for deduction*—(i) *Contents of claim.* A claim for deduction for a deficiency dividend shall be made in duplicate, with the requisite declaration, on Form 976 and shall contain the following information:

(*a*) The name and address of the corporation;

(*b*) The place and date of incorporation;

(*c*) The amount of the deficiency determined with respect to the tax imposed by section 541 (or a corresponding provision of a prior income tax law) and the taxable year or years involved; the amount of the unpaid deficiency or, if the deficiency has been paid in whole or in part, the date of payment and the amount thereof; a statement as to how the deficiency was established, if unpaid; or if paid in whole or in part, how it was established that any portion of the amount paid was a deficiency at the time when paid and, in either case whether it was by an agreement under section 547 (c) (3), by a closing agreement under section 7121, or by a decision of the Tax Court or court judgment and the date thereof; if established by a final judgment in a suit against the United States for refund, the date of payment of the deficiency, the date the claim for refund was filed, and the date the suit was brought; if established by a Tax Court decision or court judgment, a copy thereof shall be attached, together with an explanation of how the decision became final; if established by an agreement under section 547 (c) (3), a copy of such agreement shall be attached;

(*d*) The amount and date of payment of the dividend with respect to which the claim for the deduction for deficiency dividends is filed;

(*e*) A statement setting forth the various classes of stock outstanding, the name and address of each shareholder, the class and number of shares held by each on the date of payment of the dividend with respect to which the claim is filed, and the amount of such dividend paid to each shareholder;

(*f*) The amount claimed as a deduction for deficiency dividends; and

(*g*) Such other information as may be required by the claim form.

(ii) *Filing of claim and corporate resolution.* The claim in duplicate together with a certified copy of the resolution of the board of directors or other authority, authorizing the payment of the dividend with respect to which the claim is filed, shall be filed with the district director for the internal revenue district in which the return is filed.

(iii) *Carryover of deficiency dividends paid by acquiring corporation.* In the case of the acquisition of assets of a corporation by another corporation in a distribution or transfer described in section 381 (a), the distributor or transferor corporation shall be entitled to a deduction for any deficiency dividends (as defined in section 547 (d)) paid by the acquiring corporation with respect to such distributor or transferor corporation. See section 381 (c) (17).

§ 1.547–3 Claim for credit or refund.

(a) If a deficiency in personal holding company tax is asserted for any taxable year, and the corporation has paid any portion of such asserted deficiency, it is entitled to a credit or refund of such payment to the extent that such payment constitutes an overpayment as the result of a deduction for a deficiency dividend as provided in section 547 and §§ 1.547–1 through 1.547–7. It should be noted that a "determination" under section 547(c) and paragraph (b)(1) of § 1.547–2, of taxpayer's liability for personal holding company tax may take place subsequent to the time the deficiency was paid. To secure credit or refund of such overpayment, the taxpayer must file a claim on Form 843 in addition to the claim for the deduction for deficiency dividends required under section 547(e) and paragraph (b) (2) of § 1.547–2.

(b) No interest shall be allowed on such credit or refund.

(c) Such credit or refund will be allowed as if, on the date of the determination under section 547 (c) and paragraph (b) (1) of § 1.547–2, two years remained before the expiration of the period of limitation on the filing of claim for refund for the taxable year to which the overpayment relates.

§ 1.547–4 Effect on dividends paid deduction.

The deficiency dividends deduction shall be allowed as of the date the claim is filed. No duplication of deductions with respect to any deficiency dividends is permitted. If a corporation claims and receives the benefit of the provisions of section 547 (or the corresponding section 506 of the Internal Revenue Code of 1939, or section 407 of the Revenue Act of 1938 (52 Stat. 447)), based upon a distribution of deficiency dividends, that distribution does not become a part of the dividends paid deduction under section 561. Likewise, it will not be made the basis of a dividends paid deduction under section 561 by reason of the application of section 563 (b), relating to dividends paid after the close of the taxable year and on or before the 15th day of the third month following the close of such taxable year.

§ 1.547–5 Deduction denied in case of fraud or wilful failure to file timely return.

No deduction for deficiency dividends shall be allowed under section 547 (a) if the determination contains a finding that any part of the deficiency is due to fraud with intent to evade tax, or to wilful failure to file an income tax return within the time prescribed by law or prescribed by the Secretary or his delegate in pursuance of law. See § 1.547–7 for effective date.

§ 1.547–6 Suspension of statute of limitations and stay of collection.

(a) *Statute of limitations.* If the corporation files a claim for a deduction for deficiency dividends under section 547(e) and paragraph (b) (2) of § 1.547–2, the running of the statute of limitations upon assessment, distraint, and collection in court in respect of the deficiency, and all interest, additional amounts, or assessable penalties, shall be suspended for a period of two years after the date of the determination under section 547 (c) and paragraph (b) (1) of § 1.547–2.

(b) *Stay of collection.* If a deficiency in personal holding company tax is established by a determination under section 547 (c) and paragraph (b) (1) of § 1.547–2, collection by distraint or court proceeding (except in case of jeopardy), of the deficiency and all interest, additional amounts, and assessable penalties, shall be stayed for a period of 120 days after the date of such determination, and, to the extent any part of such deficiency remains after deduction for deficiency dividends, for an additional period until the date the claim is disallowed. After such claim is allowed or rejected, either in whole or in part, the amount of the deficiency which was not eliminated by the application of section 547, together with interest, additional amounts and assessable penalties, will be assessed and collected in the usual manner.

§ 1.547–7 Effective date.

The deduction for deficiency dividends, in computing personal holding company tax for any taxable year, is allowable only with respect to determinations under section 547(c) made after November 14, 1954 (the date falling 90 days after the date of enactment of the Internal Revenue Code of 1954). If the taxable year with respect to which the deficiency is asserted began before January 1, 1954, the deficiency dividends deduction shall include only the amounts which would have been includible in the computation of the basic surtax credit for such taxable year under the Internal Revenue Code of 1939. Section 547 (g), relating to the denial of a deficiency dividends deduction if the determination contains a finding that any part of the deficiency is due to fraud, etc., shall apply only if the taxable year with respect to which the deficiency is asserted begins after December 31, 1953.

FOREIGN PERSONAL HOLDING COMPANIES

§ 1.551 Statutory provisions; foreign personal holding company income taxed to United States shareholders.

SEC. 551. *Foreign personal holding company income taxed to United States shareholders—*

(a) *General rule.* The undistributed foreign personal holding company income of a foreign personal holding company shall be included in the gross income of the citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts (other than estates or trusts the gross income of which under this subtitle includes only income from sources within the United States), who are shareholders in such foreign personal holding company (hereinafter called "United States shareholders") in the manner and to the extent set forth in this part.

(b) *Amount included in gross income.* Each United States shareholder, who was a shareholder on the day in the taxable year of the company which was the last day on which a United States group (as defined in section 552 (a) (2)) existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends, the amount he would have received as a dividend if on such last day there had been distributed by the company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the company for the taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.

(c) *Deduction for obligations of United States and its instrumentalities.* Each United States shareholder shall take into account in determining his income tax his proportionate share of partially tax-exempt interest on obligations described in section 35 or 242 which is included in the gross income of the company otherwise than by the application of the provisions of section 555 (b) (relating to the inclusion in the gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another foreign personal holding company in which it is a shareholder). If the foreign personal holding company elects under section 171 to amortize the premiums on such obligations, for purposes of the preceding sentence each United States shareholder's proportionate share of such interest received by the foreign personal holding company shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 171 as is attributable to such share.

(d) *Information in return.* Every United States shareholder who is required under subsection (b) to include in his gross income any amount with respect to the undistributed foreign personal holding company income of a foreign personal holding company and who, on the last day on which a United States group existed with respect to the company, owned 5 percent or more in value of the outstanding stock of such company, shall set forth in his return in complete detail the gross income, deductions and credits, taxable income, foreign personal holding company, and undistributed foreign personal holding company income of such company.

(e) *Effect on capital account of foreign personal holding company.* An amount which bears the same ratio to the undistributed foreign personal holding company income of the foreign personal holding company for its taxable year as the portion of such taxable year up to and including the last day on which a United States group existed with respect to the company bears to the entire taxable year, shall, for the purpose of determining the effect of distributions in subsequent taxable years by the corporation, be considered as paid-in surplus or as a contribution to capital, and the accumulated earnings and profits as of the close of the taxable year shall be correspondingly reduced, if such amount or any portion thereof is required to be included as a dividend, directly or indirectly, in the gross income of United States shareholders.

(f) *Basis of stock in hands of shareholders.* The amount required to be included in the gross income of a United States shareholder under subsection (b) shall, for the purpose of adjusting the basis of his stock with respect to which the distribution would have been made (if it had been made), be treated as having been reinvested by the shareholder as a contribution to the capital of the corporation; but only to the extent to which such amount is included in his gross income in his return, increased or decreased by any adjustment of such amount in the last determination of the shareholder's tax liability, made before the expiration of 6 years after the date prescribed by law for filing the return.

(g) *Cross references.* (1) For basis of stock or securities in a foreign personal holding company acquired from a decedent, see section 1014 (b) (5).

(2) For period of limitation on assessment and collection without assessment, in case of failure to include in gross income the amount properly includible therein under subsection (b), see section 6501.

(3) For treatment of gain on liquidation of certain foreign personal holding companies, see section 342.

§ 1.551–1 General rule.

Part III (section 551 and following), subchapter G, chapter 1 of the Code, does not impose a tax on foreign personal holding companies. The undistributed foreign personal holding company income of such companies, however, must be included in the manner and to the extent set forth in section 551, in the gross income of their "United States shareholders," that is, the shareholders who are individual citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts other than estates or trusts the gross income of which under subtitle A of the Code includes only income from sources within the United States.

§ 1.551–2 Amount included in gross income.

(a) The undistributed foreign personal holding company income is included only in the gross income of the United States shareholders who were shareholders in the company on the last day of its taxable year on which a United States group (as defined in section 552 (a) (2)) existed with respect to the company. Such United States shareholders, accordingly, are determined by the stock holdings as of such specified time. This rule applies to every United States shareholder who was a shareholder in the company at the specified time regardless of whether the United States shareholder is included within the United States group. For example, a domestic corporation which is a United States shareholder at the specified time must return its distributive share in the undistributed foreign personal holding company income even though the domestic corporation cannot be included within the United States group since, under section 554, the stock it owns in the foreign corporation is considered as being owned proportionately by its shareholders for the purpose of determining whether the foreign corporation is a foreign personal holding company.

(b) The United States shareholders must include in their gross income their distributive shares of that proportion of the undistributed foreign personal holding company income for the taxable year of the company which is equal in ratio to that which the portion of the taxable year up to and including the last day on which the United States group with respect to the company existed bears to the entire taxable year. Thus, if the last day in the taxable year on which the required United States group existed was also the end of the taxable year, the portion of the taxable year up to and including such last day would be equal to

100 percent and, in such case, the United States shareholders would be required to return their distributive shares in the entire undistributed foreign personal holding company income. But if the last day on which the required United States group existed was September 30, and the taxable year was a calendar year, the portion of the taxable year up to and including such last day would be equal to nine-twelfths and, in that case, the United States shareholders would be required to return their distributive shares in only nine-twelfths of the undistributed foreign personal holding company income.

(c) The amount which each United States shareholder must return is that amount which he would have received as a dividend if the above-specified portion of the undistributed foreign personal holding company income had in fact been distributed by the foreign personal holding company as a dividend on the last day of its taxable year on which the required United States group existed. Such amount is determined, therefore, by the interest of the United States shareholder in the foreign personal holding company, that is, by the number of shares of stock owned by the United States shareholder and the relative rights of his class of stock, if there are several classes of stock outstanding. Thus, if a foreign personal holding company has both common and preferred stock outstanding and the preferred shareholders are entitled to a specified dividend before any distribution may be made to the common shareholders, then the assumed distribution of the stated portion of the undistributed foreign personal holding company income must first be treated as a payment of the specified dividend on the preferred stock before any part may be allocated as a dividend on the common stock.

(d) The assumed distribution of the required portion of the undistributed foreign personal holdng company income must be returned as dividend income by the United States shareholders for their respective taxable years in which or with which the taxable year of the foreign personal holding company ends. For example, if the M Corporation, whose taxable year is the calendar year, is a foreign personal holding company for 1954 and if A, one of its United States shareholders, makes returns on a calendar year basis, while B, another United States shareholder, makes returns on the basis of a fiscal year ending November 30, A must return his assumed dividend as income for the taxable year 1954 and B must return his distributive share as income for the fiscal year ending November 30, 1955. In applying this rule, the date as of which the United States group last existed with respect to the company is immaterial. Thus, in the foregoing example, if September 30, 1954, was the last day on which the United States group with respect to the M Corporation existed, B would still be required to return his assumed dividend as income for the fiscal year ending November 30, 1955, even though September 30, 1954, the date as of which the distribution is assumed to have been made, does not fall within such fiscal year.

(e) For the treatment of gain on the sale of certain stock, see section 306 (f) and paragraph (h) of § 1.306–3.

§ 1.551–3 Deduction for obligations of the United States and its instrumentalities.

(a) Each United States shareholder required to return his distributive share of undistributed foreign personal holding company income for any taxable year shall take into account in computing the credit against tax under section 35, or the deduction under section 242, whichever is allowable to such shareholder, his proportionate share of whatever interest on obligations of the United States or its instrumentalities (as specified in sections 35 or 242, as the case may be) may be included in the gross income of the company for such taxable year, with the exception of any such interest as may be so included by reason of the application of the provisions of section 555. For reduction of credit for such interest on account of amortizable bond premium, see section 171 and the regulations thereunder.

(b) The rule set forth in paragraph (a) of this section may be illustrated by the following example:

Example. The M Corporation is a foreign personal holding company which owns all the stock of the N Corporation, another foreign personal holding company. Both companies receive interest on obligations of the United States or its instrumentalities as specified in section 35. In determining the amount of the credit allowable under section 35 (if the shareholder is an individual) or the deduction allowable under section 242 (if the shareholder is a corporation), the United States shareholder of the M Corporation would be entitled to a credit or a deduction, as the case may be, only for his proportionate share of the interest received by that Company and not for any part of the interest received by the N Corporation, regardless of whether the interest received by the N Corporation is included in the gross income of the M Corporation as an actual dividend or as a constructive dividend under section 555.

§ 1.551–4 Information in return.

The information required by section 551(d) in the returns of certain United States shareholders relates only to the taxable year of a foreign personal holding company for which any part of such corporation's undistributed foreign personal holding company income must be included in gross income by the United States shareholder of whom the information is required. The information shall be submitted as a part of the income tax return in the form of a statement attached to the return.

§ 1.551–5 Effect on capital account of foreign personal holding company and basis of stock in hands of shareholders.

(a) Sections 551(e) and 551(f) are designed to prevent double taxation with respect to the undistributed foreign personal holding company income.

(b) The application of sections 551 (e) and 551 (f) may be illustrated by the following examples:

Example (1). The M Corporation is a foreign personal holding company. Seventy-five percent in value of its capital stock is owned by A, a citizen of the United States, and the remainder, or 25 percent, of its stock is owned by B, a nonresident alien individual. For the calendar year 1954 the M Corporation has an undistributed foreign personal holding company income of $100,000. A is required to include $75,000 of such income in gross income as a dividend in his return for the calendar year 1954. The $100,000 is treated as paid-in surplus or as a contribution to the capital of the M Corporation and its accumulated earnings and profits as of the close of the calendar year 1954 are correspondingly reduced. If after treating such $100,000 as paid-in surplus or as a contribution to capital, the M Corporation has no accumulated earnings and profits at the close of 1954, and if for the calendar year 1955, the M Corporation had no earnings and profits, but distributed $40,000, the amount so distributed would be a nontaxable distribution and would not be included in the gross income of either A or B for the calendar year 1955. If, however, after treating the $100,000 as paid-in surplus or as a contribution to capital, the M Corporation had accumulated earnings and profits of $100,000 at the close of 1954, the facts otherwise being the same, the distributions in 1955 would be taxable to A as a dividend, and the taxability of such distributions to B would depend upon the application of section 861 (a) (2), relating to the treatment of dividends from a foreign corporation as income from sources within or without the United States.

Example (2). In example (1) assume the basis of A's stock to be $300,000. If A includes in gross income in his return for the calendar year 1954, $75,000 as a dividend from the M Corporation, the basis of his stock would be $375,000. After the nontaxable distribution of $30,000 to A by the M Corporation in 1955 (75 percent of the $40,000 distribution) the basis of A's stock, assuming no other changes, would be $345,000. If A failed to include the $75,000 as a dividend in gross income in his return for 1954 and his failure was not discovered until after the 6-year period of limitations had expired, the application of the rule would not increase the basis of A's stock. The subsequent nontaxable distribution of $30,000 to A in 1955 would reduce his basis of $300,000 to $270,000, thus tending to compensate for his failure to include the amount of $75,000 as a dividend in his gross income for 1954. If the undistributed foreign personal holding company income of the M Corporation is readjusted within the statutory period of limitations, thus increasing or decreasing the amount A would have to include in his gross income, proper adjustment is required to be made to the basis of A's stock on account of such readjustment.

§ 1.552 Statutory provisions; definition of foreign personal holding company.

SEC. 552. *Definition of foreign personal holding company*—(a) *General rule.* For purposes of this subtitle, the term "foreign personal holding company" means any foreign corporation if—

(1) *Gross income requirement.* At least 60 percent of its gross income (as defined in section 555 (a)) for the taxable year is foreign personal holding company income as defined in section 553; but if the corporation is a foreign personal holding company with respect to any taxable year ending after August 26, 1937, then, for each subsequent taxable year, the minimum percentage shall be 50 percent in lieu of 60 percent, until a taxable year during the whole of which the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than 50 percent of the gross in-

come is foreign personal holding company income. For purposes of this paragraph, there shall be included in the gross income the amount includible therein as a dividend by reason of the application of section 555 (c) (2); and

(2) *Stock ownership requirement.* At any time during the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, hereinafter called "United States group".

(b) *Exceptions.* The term "foreign personal holding company" does not include—

(1) A corporation exempt from tax under subchapter F (sec. 501 and following); and

(2) A corporation organized and doing business under the banking and credit laws of a foreign country if it is established (annually or at other periodic intervals) to the satisfaction of the Secretary or his delegate that such corporation is not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed upon its shareholders. If the Secretary or his delegate is satisfied that such corporation is not so formed or availed of, he shall issue to such corporation annually or at other periodic intervals a certification that the corporation is not a foreign personal holding company.

Each United States shareholder of a foreign corporation which would, except for the provisions of paragraph (2), be a foreign personal holding company, shall attach to and file with his income tax return for the taxable year a copy of the certification by the Secretary or his delegate made pursuant to paragraph (2). Such copy shall be filed with the taxpayer's return for the taxable year if he has been a shareholder of such corporation for any part of such year.

§ 1.552–1 Definition of foreign personal holding company.

(a) A foreign personal holding company is any foreign corporation, other than a corporation exempt from taxation under subchapter F (section 501 and following), chapter 1 of the Code, and other than certain banking institutions which satisfy the requirements of section 552(b)(2) and paragraph (b) of § 1.552–4 which for the taxable year meets (1) the gross income requirement specified in section 552(a)(1); and (2) the stock ownership requirement specified in section 552(a)(2). Both requirements must be satisfied with respect to each taxable year.

(b) A foreign corporation which comes within the classification of a foreign personal holding company is not subject to taxation either under section 531 or section 541. See sections 532 (b) (2) and 542 (c) (5). The fact that a foreign corporation is a foreign personal holding company does not relieve the corporation from liability for the taxes imposed generally upon foreign corporations, such as the taxes imposed by sections 881 and 882, since such taxes apply regardless of the classification of the foreign corporation as a foreign personal holding company.

§ 1.552–2 Gross income requirement.

(a) To meet the gross income requirement, it is necessary that either of the following percentages of gross income of the corporation for the taxable year (including the additions to gross income provided in section 555 (b) as required by section 555 (c) (2)) be foreign personal holding company income as defined in section 553:

(1) 60 percent or more; or

(2) 50 percent or more if the foreign corporation has been classified as a foreign personal holding company for any taxable year ending after August 26, 1937, unless—

(i) A taxable year has intervened since the last taxable year for which it was so classified, during no part of which the stock ownership requirement specified in section 552 (a) (2) exists; or

(ii) Three consecutive years have intervened since the last taxable year for which it was so classified, during each of which its foreign personal holding company income was less than 50 percent of its gross income.

(b) In determining whether the foreign personal holding company income is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts. For meaning of gross income in this part, see section 555 and § 1.555–1.

§ 1.552–3 Stock ownership requirement.

(a) To meet the stock ownership requirement, it is necessary that at some time in the taxable year more than 50 percent in value of the outstanding stock of the foreign corporation be owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, herein referred to as "United States group." For the purpose of the requirement under section 552 (a) (2), section 554 provides that the ownership of the stock must be determined under the rules prescribed by section 544 (relating to rules for determining stock ownership in the case of personal holding companies generally). Accordingly, section 544 and §§ 1.544–1 through 1.544–7 are applicable for purposes of section 552(a)(2) and this section as if each reference in section 544 and §§ 1.544–1 through 1.544–7 to a personal holding company or to part II (section 541 and following), subchapter G, chapter 1 of the Code, was a reference to a foreign personal holding company or to part III (section 551 and following), subchapter G, chapter 1 of the Code, as the case may be.

(b) It is necessary to consider any change in the stock outstanding during the taxable year, whether in the number of shares or classes of stock, or in the ownership thereof, since a corporation comes within the classification if the statutory conditions with respect to stock ownership are present at any time during the taxable year.

(c) In determining whether the statutory conditions with respect to stock ownership are present at any time during the taxable year, the phrase "in value" shall, in the light of all the circumstances, be deemed the value of the corporate stock outstanding at such time (not including treasury stock). This value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock which is used is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class therein.

§ 1.552–4 Certain excluded banks.

(a) A corporation is excluded from the definition of "foreign personal holding company" if it is organized and doing business under the banking and credit laws of a foreign country and if it establishes to the satisfaction of the Commissioner that it was not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed on its shareholders. If this is established, the Commissioner, or such other official to whom authority may be delegated, will certify, by letter to the corporation, that it is not a foreign personal holding company.

(b) An application for certification under section 552 (b) (2) shall be made in writing to the Commissioner of Internal Revenue, Washington 25, D. C., Attention: Director of International Operations. A separate application shall be filed for each taxable year for which certification is requested, and the application shall be accompanied by a completed Form 958 for the taxable year. See section 6035. The following information shall be set forth in, or submitted with, the application:

(1) A complete reference to the banking or credit laws of the foreign country under which the corporation operates;

(2) A statement as to the extent of the corporation's business in receiving deposits and making loans and discounts and similar banking and credit operations;

(3) A statement as to the extent of the operations of the corporation other than such banking and credit operations;

(4) A statement as to whether the banking and credit operations of the corporation are customary for it;

(5) A statement setting forth the degree and manner of supervision exercised over it by the foreign government under its banking and credit laws; a copy (in English) of the corporation's last annual financial statement, as submitted to the Government authority having jurisdiction over it, shall be submitted with the application;

(6) A statement setting forth the business reasons of the corporation for not distributing the amount which would be its undistributed foreign personal holding company income if the corporation were not excluded under section 552 (b);

(7) A statement setting forth the extent of the corporation's profits which must be retained as reserves under the foreign law;

(8) A statement setting forth the date or dates when the corporation reasonably expects to distribute is undistributed foreign personal holding company income for the taxable year;

(9) A statement setting forth the name and address of each of the individuals described in section 552(a)(2), the extent of their stock ownership in the corporation, and the amount of distributions or other payments to such stockholders, including, but not limited to, dividends, compensation, interest, and rents; and

(10) Any other facts or information the corporation may wish to submit to show that it was not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed on its shareholders.

The corporation shall also furnish such other information requested as necessary by the Director of International Operations. The application for certification, together with the information required by this paragraph, should be filed within 60 days after the close of the taxable year of the corporation or before November 9, 1958, whichever is later. However, if the corporation is unable, for good cause, to submit the application for certification within such 60-day period, additional time may be granted by the Director of International Operations upon receipt of a request from the corporation setting forth the reasons for such request.

§ 1.552–5 United States shareholder of excluded bank.

A copy of the certification issued to an excluded bank under section 552(b)(2) and § 1.552–4 shall be filed with, and made a part of, the income tax return for the taxable year of each United States shareholder of such foreign corporation, if he has been a shareholder of such corporation for any part of such year. If the certificate has not been issued at the time the return of the United States shareholder is filed, the shareholder shall compute the tax on his return by treating the bank as a foreign personal holding company. If a certificate is issued after the return is filed, the United States shareholder may file a claim for refund or an amended return, and shall attach thereto a copy of the certification.

§ 1.553 Statutory provisions; foreign personal holding company income.

SEC. 553. *Foreign personal holding company income.* For purposes of this subtitle, the term "foreign personal holding company income" means the portion of the gross income, determined for purposes of section 552, which consists of personal holding company income, as defined in section 543, except that all interest, whether or not treated as rent, and all royalties, whether or not mineral, oil, or gas royalties, shall constitute "foreign personal holding company income".

§ 1.553–1 Foreign personal holding company income.

Foreign personal holding company income shall consist of the items defined under section 543 and §§ 1.543–1 and 1.543–2, relating to personal holding company income, with the following exceptions:

(a) The entire amount received as "interest", whether or not treated as rent, shall be considered to be foreign personal holding company income. Thus, the exception in the second sentence of section 543 (a) (1) and paragraph (b) (2) of § 1.543–1 (relating to interest treated as rent under section 543 (a) (7) and paragraph (b) (10) of § 1.543–1), is inapplicable for the purpose of determining foreign personal holding company income. Similarly, section 543 (a) (7) and paragraph (b) (10) of § 1.543–1 are applied for this purpose without regard to the interest described in that section.

(b) (1) The entire amount received as "royalties", whether or not mineral, oil, or gas royalties, shall be considered to be foreign personal holding company income. Thus, subparagraphs (A) and (B) of section 543 (a) (8) and paragraph (b) (11) (i) (*a*) and (*b*) of § 1.543–1 are inapplicable for the purpose of determining foreign personal holding company income.

(2) In computing foreign personal holding company income, the first sentence of paragraph (b) (11) (ii) of § 1.543–1 shall apply to overriding royalties received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid, and to mineral, oil, or gas production payments, only with respect to amounts received after September 30, 1958.

§ 1.554 Statutory provisions; stock ownership.

SEC. 554. *Stock ownership.* For purposes of determining whether a foreign corporation is a foreign personal holding company, insofar as such determination is based on stock ownership, the rules provided in section 544 shall be applicable as if any reference in such section to a personal holding company was a reference to a foreign personal holding company and as if any reference in such section to a provision of part II (relating to personal holding companies) was a reference to the corresponding provision of this part.

§ 1.554–1 Stock ownership.

For regulations under section 554, see § 1.552–3.

§ 1.555 Statutory provisions; gross income of foreign personal holding companies.

SEC. 555. *Gross income of foreign personal holding companies*—(a) *General rule.* For purposes of this part, the term "gross income" means, with respect to a foreign corporation, gross income computed (without regard to the provisions of subchapter N (sec. 861 and following)) as if the foreign corporation were a domestic corporation which is a personal holding company.

(b) *Additions to gross income.* In the case of a foreign personal holding company (whether or not a United States group, as defined in section 552 (a) (2), existed with respect to such company on the last day of its taxable year) which was a shareholder in another foreign personal holding company on the day in the taxable year of the second company which was the last day on which a United States group existed with respect to the second company, there shall be included, as a dividend, in the gross income of the first company, for the taxable year in which or with which the taxable year of the second company ends, the amount the first company would have received as a dividend if on such last day there had been distributed by the second company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the second company for its taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.

(c) *Application of subsection (b).* The rule provided in subsection (b)—

(1) Shall be applied in the case of a foreign personal holding company for the purpose of determining its undistributed foreign personal holding company income which, or a part of which, is to be included in the gross income of its shareholders, whether United States shareholders or other foreign personal holding companies;

(2) Shall be applied in the case of every foreign corporation with respect to which a United States group exists on some day of its taxable year, for the purpose of determining whether such corporation meets the gross income requirements of section 552 (a) (1).

§ 1.555–1 General rule.

The gross income of a foreign corporation which is a foreign personal holding company is computed the same as if the foreign corporation were a domestic corporation which is a personal holding company. See section 542(a)(1) and § 1.542–2. The gross income of a foreign personal holding company thus includes income from all sources, whether within or without the United States, which is not specifically excluded from gross income under any other provisions of the Code. For example, the gross income of a foreign personal holding company includes all income from sources outside the United States even though the foreign personal holding company is a foreign corporation not engaged in trade or business within the United States.

§ 1.555–2 Additions to gross income.

(a) If, for any taxable year—

(1) A foreign corporation meets the stock ownership requirement specified in section 552 (a) (2) and § 1.552–3, regardless of whatever day in its taxable year is the last day on which the required United States group exists, and

(2) Such foreign corporation is a shareholder in a foreign personal holding company on any day of a taxable year of the second company which ends with or within the taxable year of the first company and such day is the last day in the taxable year of the second company in which the United States group exists with respect to the second company, then for the purpose of—

(i) Determining whether the first company meets the specified gross income requirement so as to come within the classification of a foreign personal holding company, and

(ii) Determining the undistributed foreign personal holding company income of the first company which (in the event the first company is a foreign personal holding company) is to be included, in whole or in part, in the gross income of its shareholders, whether United States shareholders or other foreign personal holding companies,

there shall be included as a dividend in the gross income of the first company for the taxable year in which or with which the taxable year of the second company ends, the amount the first com-

holding company income of the X Corporation includible in the gross income of its

within the taxable year of the Y Corporation, the undistributed foreign personal holding company income of the Z Corporation would

pany would have received as a dividend, if on the last day referred to in this subparagraph there had been distributed by the second company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the second company for its taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year. The foregoing rules apply to any chain of foreign corporations regardless of the number of corporations included in the chain.

(b) The application of section 555 (b) may be illustrated by the following examples:

Example (*1*). The X Corporation is a foreign corporation whose stock is owned by A, a United States citizen. The X Corporation owns the entire stock of the Y Corporation, another foreign corporation. The taxable year of the X Corporation is the calendar year and the taxable year of the Y Corporation is the fiscal year ending June 30. For the fiscal year ending June 30, 1955, more than the required percentage of the Y Corporation's gross income consists of foreign personal holding company income and no part of the earnings for such year is distributed as dividends. On the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1955. The X Corporation meets the stock ownership requirement and constitutes a foreign personal holding company for 1955, if it also meets the gross income requirement. For the purpose of determining whether the X Corporation meets the gross income requirement, the entire undistributed foreign personal holding company income of the Y Corporation for the fiscal year ending June 30, 1955, must be included as a dividend in the gross income of the X Corporation for 1955, since—

(1) The X Corporation was a shareholder in the Y Corporation on a day (June 30, 1955) in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation, which day was the last day in the taxable year of the Y Corporation on which the United States group required with respect to the Y Corporation existed,

(2) Such last day was also the end of the Y Corporation's taxable year so that the portion of the taxable year of the Y Corporation up to and including such last day is equal to 100 percent of the taxable year of the Y Corporation, and, therefore, the portion of the undistributed foreign personal holding company income of the Y Corporation includible in the gross income of its shareholders is likewise equal to 100 percent, and

(3) The X Corporation being the sole shareholder of the Y Corporation must include such portion in its gross income for 1955, the taxable year in which or with which the taxable year of the Y Corporation ends. If, after the inclusion of the presumptive dividend in its gross income, the X Corporation is a foreign personal holding company for 1955, then the undistributed foreign personal holding company income of the Y Corporation must also be included as a dividend in the gross income of the X Corporation in determining its undistributed foreign personal holding company income which is to be included in the gross income of A, the sole shareholder in the X Corporation. On the other hand, if, after including such presumptive dividend, the X Corporation does not constitute a foreign personal holding company, the undistributed foreign personal holding company income of the Y Corporation is not includible in the gross income of the X Corporation.

Example (*2*). The X Corporation referred to in example (1) sold the stock in the Y Corporation to other interests on September 30, 1955, so that after that date no United States group existed with respect to the Y Corporation. For the fiscal year ending June 30, 1956, more than the required percentage of the gross income of the Y Corporation consists of foreign personal holding company income. The taxable income of the Y Corporation for such fiscal year amounts to $1,000,000, of which $900,000 is distributed in dividends after September 30, 1955. The undistributed foreign personal holding company income of the Y Corporation for such fiscal year amounts to $100,000. Upon the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1956, since at one time in such fiscal year, or from July 1 to and including September 30, 1955, it meets the stock ownership requirement, and the gross income requirement is also satisfied. In determining whether the X Corporation constitutes a foreign personal holding company for 1956, a portion of the undistributed foreign personal holding company income of the Y Corporation for the fiscal year ending June 30, 1956 (three-twelfths of $100,000, or $25,000), must be included as a dividend in the gross income of the X Corporation, since—

(1) The X Corporation was a shareholder in the Y Corporation on September 30, 1955, or on a day in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation which day was the last day in the Y Corporation's taxable year on which the United States group required with respect to the Y Corporation existed.

(2) The portion of the taxable year of the Y Corporation up to and including such day is three-twelfths of the entire taxable year of the Y Corporation and, therefore, the portion of the undistributed foreign personal holding company income of the Y Corporation includible in the gross income of its shareholders also is equal to three-twelfths, and

(3) The X Corporation, being the sole shareholder of the Y Corporation at the time the United States group with respect to the Y Corporation last existed, must include all of such portion in its gross income for 1956, the taxable year of the X Corporation in which or with which the taxable year of the Y Corporation ends.

It is to be observed that three-twelfths of the undistributed foreign personal holding company income of the Y Corporation for the entire taxable year and not the earnings realized by the Y Corporation up to and including September 30, 1955, the last day on which the United States group with respect to the Y Corporation existed, must be included in the gross income of the X Corporation.

Example (*3*). The X Corporation referred to in example (1) sold the stock in the Y Corporation to other interests on September 30, 1955, so that after that date a different United States group existed with respect to the Y Corporation. Assuming that the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1956, no part of the undistributed foreign personal holding company income of the Y Corporation for such fiscal year would, in this instance, be includible in the gross income of the X Corporation for the year 1956, in determining whether the X Corporation is a foreign personal holding company for that year. In such case, the undistributed foreign personal holding company income of the Y Corporation is includible in the gross income of the other foreign personal holding companies, if any, and of the United States shareholders who are shareholders in the Y Corporation the day after September 30, 1955, which was the last day in the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation existed. If, however, the X Corporation sells 90 percent of its stock in the Y Corporation and thus is a minority shareholder in the Y Corporation on the last day of the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation exists, the portion of the undistributed foreign personal holding company income allocable to the minority interests of the X Corporation would be includible in the gross income of the X Corporation, even though on such last day the United States group is not the same with respect to both corporations.

Example (*4*). If the Y Corporation in example (1) owns all of the stock of the Z Corporation, another foreign corporation, there would be a chain of three foreign corporations. In such case, assuming that the Z Corporation is a foreign personal holding company for a taxable year ending with or within the taxable year of the Y Corporation, the undistributed foreign personal holding company income of the Z Corporation would be included in the gross income of the Y Corporation for the purpose of determining whether the Y Corporation comes within the classification of a foreign personal holding company. If, after the inclusion of such presumptive dividend, the Y Corporation is a foreign personal holding company, the undistributed foreign personal holding company income of the Z Corporation would be included in the gross income of the Y Corporation in determining the undistributed foreign personal holding company income of the Y Corporation which is includible in the gross income of its shareholder, the X Corporation. The same process would be repeated with respect to determining whether the X Corporation is a foreign personal holding company and in determining its undistributed foreign personal holding company income. If all three corporations are foreign personal holding companies, the undistributed foreign personal holding company income of each would, in this manner, be reflected as a dividend in the gross income of A, the ultimate beneficial shareholder of the chain. In the event that after the inclusion of the undistributed foreign personal holding company income of the Z Corporation in the gross income of the Y Corporation, the Y Corporation is not a foreign personal holding company, then no part of the income of either the Z Corporation or the Y Corporation would be includible in the gross income of the X Corporation. In that event, whether the X Corporation is a foreign personal holding company, and its undistributed foreign personal holding company income, would be determined independently of the income of the Y Corporation and the Z Corporation.

§ 1.556 Statutory provisions; undistributed foreign personal holding company income.

SEC. 556. *Undistributed foreign personal holding company income*—(a) *Definition.* For purposes of this part, the term "undistributed foreign personal holding company income" means the taxable income of a foreign personal holding company adjusted in the manner provided in subsection (b), minus the dividends paid deduction (as defined in section 561).

(b) *Adjustments to taxable income.* For the purposes of subsection (a), the taxable income shall be adjusted as follows:

(1) *Taxes.* There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits, and excess-profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164 (b) (6)),

accrued during the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law. A taxpayer which, for each taxable year in which it was subject to the provisions of supplement P of the Internal Revenue Code of 1939, deducted Federal income and excess profits taxes when paid for the purpose of computing undistributed supplement P net income under such code, shall deduct taxes under this paragraph when paid, unless the corporation elects, under regulations prescribed by the Secretary or his delegate, after the date of enactment of this title to deduct the taxes described in this paragraph when accrued. Such election shall be irrevocable and shall apply to the taxable year for which the election is made and to all subsequent taxable years.

(2) *Charitable contributions.* The deduction for charitable contributions provided under section 170 shall be allowed, but in computing such deduction the limitations in section 170(b)(1) (A) and (B) shall apply, and section 170(b)(2) shall not apply. For purposes of this paragraph, the term "adjusted gross income" when used in section 170(b)(1) means the taxable income computed with the adjustments (other than the 5-percent limitation) provided in the first sentence of section 170(b)(2) and without the deduction of the amounts disallowed under paragraphs (5) and (6) of this subsection or the inclusion in gross income of the amounts includible therein as dividends by reason of the application of the provisions of section 555(b) (relating to the inclusion in gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another company in which it is a shareholder).

(3) *Special deductions disallowed.* The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) *Net operating loss.* The net operating loss deduction provided in section 172 shall not be allowed, but there shall be allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year computed without the deductions provided in part VIII (except section 248) of subchapter B.

(5) *Expenses and depreciation applicable to property of the taxpayer.* The aggregate of the deductions allowed under section 162 (relating to trade or business expenses) and section 167 (relating to depreciation) which are allocable to the operation and maintenance of property owned or operated by the company, shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established (under regulations prescribed by the Secretary or his delegate) to the satisfaction of the Secretary or his delegate—

(A) That the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

(B) That the property was held in the course of a business carried on bona fide for profit; and

(C) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(6) *Taxes and contributions to pension trusts.* The deductions provided in section 164 (c) (relating to taxes of a shareholder paid by the corporation) and in section 404 (relating to pension, etc., trusts) shall not be allowed.

[Sec. 556 as amended by sec. 33, Technical Amendments Act 1958 (72 Stat. 1632)]

§ 1.556–1 Definition.

Undistributed foreign personal holding company income is the amount which is to be included in the gross income of the United States shareholders under section 551(b) and § 1.551–2. Undistributed foreign personal holding company income is the taxable income of the foreign personal holding company, as defined in section 63(a) (computed without regard to subchapter N, chapter 1 of the Code), and adjusted in the manner described in section 556(b) and § 1.556–2, less the deduction for dividends paid (§§ 1.561 through 1.565–6). See § 1.556–3 for an illustration of the computation of undistributed foreign personal holding company income.

§ 1.556–2 Adjustments to taxable income.

(a) *Taxes*—(1) *General rule.* (i) In computing undistributed foreign personal holding company income for any taxable year, there shall be allowed as a deduction the Federal income and excess profits taxes accrued during the taxable year except that no deduction shall be allowed for (*a*) the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), (*b*) the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (*c*) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940. The deduction is for taxes for the taxable year determined under the accrual method of accounting, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursements method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(ii) However, the corporation shall deduct taxes paid, rather than taxes accrued, if it used that method with respect to Federal taxes for each taxable year for which it was subject to the provisions of supplement P, subchapter C, chapter 1 of the Internal Revenue Code of 1939, unless an election is made under subparagraph (2) of this paragraph to deduct taxes accrued.

(2) *Election by corporation which deducted taxes paid.* (i) If the corporation was subject to supplement P, subchapter C, chapter 1 of the Internal Revenue Code of 1939, and, for the purpose of computing undistributed supplement P net income under such Code, deducted Federal taxes paid, rather than such taxes accrued, for each taxable year for which it was subject to supplement P of the 1939 Code, the corporation may elect for any taxable year ending after August 16, 1954, to deduct taxes accrued, rather than taxes paid, for the purpose of computing its undistributed foreign personal holding company income. The election shall be made by deducting such taxes accrued in the return (Form 958) required to be filed for such taxable year. The return shall, in addition, contain a statement that the corporation has made such election and shall set forth the year to which such election was first applicable. The deduction of taxes accrued in the year of election precludes the deduction of taxes paid during such year. The election, if made, shall be irrevocable and the deduction for taxes accrued shall be allowed for the year of election and for all subsequent taxable years. See section 6035 and the regulations thereunder for rules relative to the filing of returns of officers, directors, and shareholders of foreign personal holding companies.

(ii) Pursuant to section 7851 (a) (1) (C), the election provided for in subdivision (i) of this subparagraph may be made with respect to a taxable year ending after August 16, 1954, even though such taxable year is subject to the Internal Revenue Code of 1939.

(3) *Taxes of foreign countries and United States possessions.* In computing taxable income, a foreign personal holding company is allowed a deduction under section 164 for income, war profits, and excess-profits taxes paid or accrued during the taxable year to foreign countries or possessions of the United States, but is not allowed the foreign tax credit under section 901. Therefore, in computing undistributed foreign personal holding company income for any taxable year, no adjustment under section 556 (b) (1) is allowed for such taxes.

(b) *Charitable contributions.* (1) Section 556(b)(2) provides that, in computing the deduction for charitable contributions for purposes of determining the undistributed foreign personal holding company income of a corporation, the limitations in section 170(b)(1) (A) and (B) (relating to charitable contributions by individuals) shall apply and section 170(b)(2) (relating to charitable contributions by corporations) shall not apply.

(2) Although the limitations of section 170(b)(1) (A) and (B) are 10 and 20 percent, respectively, of the individual's adjusted gross income, the limitations are applied for purposes of section 556(b)(2) by using 10 and 20 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2) (that is, the same amount of taxable income to which the 5-percent limitation applied). Thus, the term "adjusted gross income" when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments (other than the 5-percent limitation) provided in the first sentence of section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 556(b)(5) (relating to expenses and depreciation applicable to property of the taxpayer), and section 556(b)(6) (relating to taxes and contributions to pension trusts), and without the inclusion of the amounts includible as dividends under section 555(b) (relating to the inclusion in gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another company in which it is a shareholder). The carryover of chari-

ceived from the principal shareholder of the

table contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(2), shall not be allowed as a deduction in computing undistributed foreign personal holding company income for any taxable year.

(3) See the regulations under section 170(b)(1) (A) and (B) with respect to the charitable contributions to which the 10-percent limitation is applicable and the charitable contributions to which the 20-percent limitation is applicable.

(c) *Special deductions disallowed.* Part VIII, subchapter B, chapter 1 of the Code allows corporations special deductions in computing taxable income for such matters as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, organizational expenses, etc. See section 241. For purposes of computing undistributed foreign personal holding company income, such special deductions, except the deduction provided by section 248 (relating to organizational expenditures) and, with respect to such a computation for a taxable year ending before January 1, 1958, the deduction provided by section 242 (relating to partially tax-exempt interest), shall be disallowed.

(d) *Net operating loss.* The net operating loss deduction provided in section 172 is not allowed for purposes of the computation of undistributed foreign personal holding company income. For purposes of such a computation, however, there is allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year, except that, in computing undistributed foreign personal holding company income for a taxable year ending after December 31, 1957, the amount of such net operating loss shall be computed without the deductions provided in part VIII (section 241 and following) except section 248, relating to organizational expenditures, subchapter B, chapter 1 of the Code.

(e) *Expenses and depreciation applicable to property of the corporation.* (1) Section 556 (b) (5) provides a specific limitation in computing undistributed foreign personal holding company income, with respect to the allowance of deductions for trade or business expenses and depreciation which are allocable to the operation and maintenance of property owned or operated by a foreign personal holding company. Under this limitation these deductions shall not be allowed in excess of the aggregate amount of the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner—

(i) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(ii) That the property was held in the course of a business carried on bona fide for profit; and

(iii) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(2) The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If a United States shareholder, in computing his distributive share of undistributed foreign personal holding company income to be included in gross income in his individual return (see section 551, and §§ 1.551–1 and 1.551–2), claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, he shall attach to his income tax return a statement setting forth his claim for allowance of the additional deductions, together with a complete statement of the facts and circumstances pertinent to his claim and the arguments on which he relies. Such statement shall set forth—

(i) A description of the property;

(ii) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(iii) The name and address of the person from whom the property was acquired and the date the property was acquired;

(iv) The name and address of the person to whom the property is leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(v) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;

(vi) Evidence that the rent or other compensation was the highest obtainable, or, if none was received, a statement of the reasons therefor;

(vii) A copy of the contract, lease or rental agreement;

(viii) The purpose for which the property was used;

(ix) The business carried on by the corporation with respect to which the property was held and the gross income, expenses, and taxable income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(x) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(xi) Any other information pertinent to the taxpayer's claim.

(f) *Taxes and contributions to pension trusts.* Section 164 (e) provides for deduction by a corporation for taxes of a shareholder paid by it; section 404 provides for deduction by an employer for its contributions to an employees' trust, etc. For the purpose of computing undistributed foreign personal holding company income, neither of these deductions is allowable.

§ 1.556–3 Illustration of computation of undistributed foreign personal holding company income.

The method of computation of the undistributed foreign personal holding company income may be illustrated by the following example:

Example. (a) The following facts exist with respect to the M Corporation, a foreign personal holding company, for the calendar year 1954:

(1) The gross income of the corporation as defined in section 555 amounts to $300,000, of which $85,000 represents its distributive share of the undistributed foreign personal holding company income of another foreign personal holding company in which it is a shareholder, $200,000 consists of dividends, $10,000 consists of fully taxable interest, and the remainder ($5,000) consists of rent received from the principal shareholder of the corporation for the use of property owned by the corporation.

(2) The expenses of the corporation amount to $85,000, of which $75,000 is allocable to the maintenance and operation of the property used by the principal shareholder and $10,000 consists of ordinary and necessary office expenses allowable as a deduction. The claim for deduction for the expenses of, and depreciation on, the rented property in excess of the rent received for its use is not established as provided in section 556 (b) (5). The yearly depreciation on the rented property amounts to $30,000.

(3) Federal income tax withheld at the source on the income of the corporation from sources within the United States amounts to $59,125.

(4) No gain from the sale or exchange of stock or securities is realized during the taxable year, but losses in the amount of $10,000 are sustained from the sale of stock or securities which constitute capital assets. Such losses are not allowed as a deduction in any amount. See section 1211 (a).

(5) Contributions, payment of which is made to or for the use of donees described in section 170 (b) (1) (A) for the purposes therein specified, amount to $15,000, of which $5,000 is deductible in computing taxable income under section 63.

(6) Dividends paid by the corporation to its shareholders during the taxable year amount to $50,000.

(b) The taxable income of the corporation (including the distributive share of the undistributed foreign personal holding company income of the other foreign personal holding company) is $180,000, computed as follows (assuming for the purposes of this example only that the expenses of, and depreciation on, the rental property are deductible under sections 162 and 167):

Income (Section 61)

Dividends	$200,000
Interest	10,000
Rent	5,000
Gross income as defined in section 61	215,000
Add:	
Distributive share of undistributed income of the other foreign personal holding company (considered as a dividend)	85,000
Gross income as defined in section 555	300,000

Deductions (Section 161)

Expenses allocable to operation of the rented property	$75,000
Depreciation of the rented property	30,000
Ordinary and necessary expenses (office)	10,000

Deductions (Section 161)—Continued

Contributions (within the 5-percent limitation specified in section 170 (b) (2)----------	$5,000
	120,000
Taxable income for purposes of computing undistributed foreign personal holding company income------	180,000

(c) The undistributed foreign personal holding company income of the corporation is $160,875, computed as follows:

Taxable income for purposes of computing undistributed foreign personal holding company income----------	$180,000
Add (see section 556 (b)):	
Contributions deductible in computing taxable income under section 63----------	5,000
Excess property expenses and depreciation over amount of rent received for use of property ($105,000—$5,000) ----------	100,000
Total----------	105,000
Deduct (see section 556 (b)):	
Federal income taxes----------	59,125
Contributions (within the percentage limitations specified in section 170 (b) (1) (A) and (B), determined under the rules provided in section 556 (b) (2))----------	15,000
Total----------	74,125
Net additions under section 556 (b)----------	30,875
Taxable income, as adjusted under section 556 (b)----	210,875
Less: Deduction for dividends paid (see section 561)----------	50,000
Undistributed foreign personal holding company income----------	160,875

§ 1.557 Statutory provisions; income not placed on annual basis.

SEC. 557. *Income not placed on annual basis.* Section 443 (b) (relating to computation of tax on change of annual accounting period) shall not apply in the computation of the undistributed foreign personal holding company income under section 556.

§ 1.558 Statutory provisions; returns of officers, directors, and shareholders of foreign personal holding companies.

SEC. 558. *Returns of officers, directors, and shareholders of foreign personal holding companies.* For provisions relating to returns of officers, directors, and shareholders of foreign personal holding companies, see section 6035.

[Sec. 558 as added by sec. 33(d), Technical Amendments Act 1958 (72 Stat. 1632)]

DEDUCTION FOR DIVIDENDS PAID

§ 1.561 Statutory provisions; definition of deduction for dividends paid.

SEC. 561. *Definition of deduction for dividends paid*—(a) *General rule.* The deduction for dividends paid shall be the sum of—

(1) The dividends paid during the taxable year,

(2) The consent dividends for the taxable year (determined under section 565), and

(3) In the case of a personal holding company, the dividend carryover described in section 564.

(b) *Special rules applicable.* In determining the deduction for dividends paid, the rules provided in section 562 (relating to rules applicable in determining dividends eligible for dividends paid deduction) and section 563 (relating to dividends paid after the close of the taxable year) shall be applicable.

§ 1.561–1 Deduction for dividends paid.

(a) The deduction for dividends paid is applicable in determining accumulated taxable income under section 535, undistributed personal holding company income under section 545, undistributed foreign personal holding company income under section 556, and investment company taxable income under section 852. The deduction for dividends paid includes—

(1) The dividends paid during the taxable year;

(2) The consent dividends for the taxable year, determined as provided in section 565; and

(3) In the case of a personal holding company, the dividend carryover computed as provided in section 564.

(b) For dividends for which the dividends paid deduction is allowable, see section 562 and § 1.562–1. As to when dividends are considered paid, see § 1.561–2.

§ 1.561–2 When dividends are considered paid.

(a) *In general.* (1) A dividend will be considered as paid when it is received by the shareholder. A deduction for dividends paid during the taxable year will not be permitted unless the shareholder receives the dividend during the taxable year for which the deduction is claimed. See section 563 for special rule with respect to dividends paid after the close of the taxable year.

(2) If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mails, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by the shareholder within the taxable year, a presumption arises that the dividend was paid to the shareholder in such year.

(3) The payment of a dividend during the taxable year to the authorized agent of the shareholder will be deemed payment of the dividend to the shareholder during such year.

(4) If a corporation, instead of paying the dividend directly to the shareholder, credits the account of the shareholder on the books of the corporation with the amount of the dividend, the deduction for a dividend paid will not be permitted unless it be shown to the satisfaction of the Commissioner that such crediting constituted payment of the dividend to the shareholder within the taxable year.

(5) A deduction will not be permitted for the amount of a dividend credited during the taxable year upon an obligation of the shareholder to the corporation unless it is shown to the satisfaction of the Commissioner that such crediting constituted payment of the dividend to the shareholder within the taxable year.

(6) If the dividend is payable in obligations of the corporation, they should be entered or registered in the taxable year on the books of the corporation, in the name of the shareholder (or his nominee or transferee), and, in the case of obligations payable to bearer, should be received in the taxable year by the shareholder (or his nominee or transferee) to constitute payment of the dividend within the taxable year.

(7) In the case of a dividend from which the tax has been deducted and withheld as required by chapter 3 (section 1441 and following), of the Code the dividend is considered as paid when such deducting and withholding occur.

(b) *Methods of accounting.* The determination of whether a dividend has been paid to the shareholder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books or upon the method of accounting upon the basis of which the taxable income of the corporation is computed.

(c) *Records.* Every corporation claiming a deduction for dividends paid shall keep such permanent records as are necessary (1) to establish that the dividends with respect to which such deduction is claimed were actually paid during the taxable year and (2) to supply the information required to be filed with the income tax return of the corporation. Such corporation shall file with its return (i) a copy of the dividend resolution; and (ii) a concise statement of the pertinent facts relating to the payment of the dividend, clearly specifying (*a*) the medium of payment and (*b*) if not paid in money, the fair market value and adjusted basis (or face value, if paid in its own obligations) on the date of distribution of the property distributed and the manner in which such fair market value and adjusted basis were determined. Canceled dividend checks and receipts obtained from shareholders acknowledging payment of dividends paid otherwise than by check need not be filed with the return but shall be kept by the corporation as a part of its records.

§ 1.562 Statutory provisions; rules applicable in determining dividends eligible for dividends paid deduction.

SEC. 562. *Rules applicable in determining dividends eligible for dividends paid deduction*—(a) *General rule.* For purposes of this part, the term "dividend" shall, except as otherwise provided in this section, include only dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions).

(b) *Distributions in liquidation.* In the case of amounts distributed in liquidation, the part of such distribution which is properly chargeable to earnings and profits accumulated after February 28, 1913, shall be treated as a dividend for purposes of computing the dividends paid deduction. In the case of a complete liquidation occurring within 24 months after the adoption of a plan of liquidation, any distribution within such period pursuant to such plan shall, to the extent of the earnings and profits (computed without regard to capital losses) of the corporation for the taxable year in which such distribution is made, be treated as a dividend for purposes of computing the dividends paid deduction.

(c) *Preferential dividends.* The amount of any distribution shall not be considered as a dividend for purposes of computing the dividends paid deduction, unless such distri-

bution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference.

(d) *Distributions by a member of an affiliated group.* In the case where a corporation which is a member of an affiliated group of corporations filing or required to file a consolidated return for a taxable year is required to file a separate personal holding company schedule for such taxable year, a distribution by such corporation to another member of the affiliated group shall be considered as a dividend for purposes of computing the dividends paid deduction if such distribution would constitute a dividend under the other provisions of this section to a recipient which is not a member of an affiliated group.

§ 1.562–1 Dividends for which the dividends paid deduction is allowable.

(a) *General rule.* Except as otherwise provided in section 562 (b) and (d), the term "dividend", for purposes of determining dividends eligible for the dividends paid deduction, refers only to a dividend described in section 316 (relating to definition of dividends for purposes of corporate distributions). No distribution, however, which is preferential within the meaning of section 562 (c) and § 1.562–2 shall be eligible for the dividends paid deduction. Further, for purposes of the dividends paid deduction, the term "dividend" does not include a distribution in liquidation unless the distribution qualifies under section 562 (b) and paragraph (b) of this section. If a dividend is paid in property (other than money) the amount of the dividend paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution. See paragraph (c) of this section for a special rule for personal holding companies. Also see section 563 for special rules with respect to dividends paid after the close of the taxable year.

(b) *Distributions in liquidation*—(1) *Distributions in liquidation for which the dividends paid deduction is allowable.* In the case of amounts distributed in liquidation section 562 (b) makes an exception to the general rule that a deduction for dividends paid is permitted only with respect to dividends described in section 316. In order to qualify under that exception, the distribution must be one either in complete or partial liquidation of a corporation pursuant to sections 331, 332, or 333. As provided by section 346 (a), for the purposes of section 562 (b), a partial liquidation includes a redemption of stock to which section 302 applies. Amounts distributed in liquidation in a transaction which is preceded, or followed, by a transfer to another corporation of all or part of the assets of the liquidating corporation, may not be eligible for the dividends paid deduction.

(2) *Amount of dividends paid deduction allowable*—(i) *General rule.* In the case of distributions in liquidation with respect to which a deduction for dividends paid is permissible under subparagraph (1) of this paragraph, the amount of the deduction is equal to the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings or profits accumulated after February 28, 1913, there must be deducted from the amount of the distribution that part allocable to capital account. The capital account, for the purposes of this subparagraph, includes not only amounts representing the par or stated value of the stock with respect to which the liquidation distribution is made, but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings or profits accumulated after February 28, 1913. Thus, if there is a deficit in earnings and profits on the first day of a taxable year, and the earnings and profits for such taxable year do not exceed such deficit, no dividends paid deduction would be allowed for such taxable year with respect to a distribution in liquidaton; if the earnings and profits for such taxable year exceed the deficit in earnings and profits which existed on the first day of such taxable year, then a dividends paid deduction would be allowable to the extent of such excess.

(ii) *Special rule.* Section 562 (b) provides that in the case of a complete liquidation occurring within 24 months after the adoption of a plan of liquidation the amount of the deduction is equal to the earnings and profits for each taxable year in which distributions are made. Thus, if there is a distribution in liquidation pursuant to section 333, or a distribution in complete liquidation pursuant to section 331 (a) (1) or 332 which occurs within a 24-month period after the adoption of a plan of liquidation, a dividends paid deduction will be allowable to the extent of the current earnings and profits for the taxable year or years even though there was a deficit in earnings and profits on the first day of such taxable year or years. In computing the earnings and profits for the taxable year in which the distributions are made, computation shall be made with the inclusion of capital gains and without any deduction for capital losses.

(iii) *Examples.* The application of this subparagraph may be illustrated by the following examples:

Example (1). The Y Corporation, which makes its income tax returns on the calendar year basis, was organized on January 1, 1910, with an authorized and outstanding capital stock of 2,000 shares of common stock of a par value of $100 each and 1,000 shares of participating preferred stock of a par value of $100 each. The preferred stock was to receive annual dividends of $7 per share and $100 per share on complete liquidation of the corporation in priority to any payments on common stock, and was to participate equally with the common stock in either instance after the common stock had received a similar amount. However, the preferred stock was redeemable in whole or in part at the option of the board of directors at any time at $106 per share plus its proportion of the earnings of the company at the time of such redemption. In 1910 the preferred stock was issued at $106 per share, for a total of $106,000 and the common stock was issued, at $100 per share, for a total of $200,000. On July 15, 1954, the company had a paid-in surplus of $6,000, consisting of the premium received on the preferred stock; earnings or profits of $30,000 accumulated prior to March 1, 1913; and earnings or profits accumulated since February 28, 1913, of $75,000. On July 15, 1954, the option with respect to the preferred stock was exercised and the entire amount of such stock was redeemed at $141 per share or a total of $141,000 in a transaction upon which gain or loss to the distributees resulting from the exchange was determined and recognized under section 302 (a). The amount of the distribution allocable to capital account was $116,000 ($100,000 attributable to par value, $6,000 attributable to paid-in surplus, and $10,000 attributable to earnings or profits accumulated prior to March 1, 1913). The remainder, $25,000 ($141,000, the amount of the distribution, less $116,000, the amount allocable to capital account) is properly chargeable to the earnings or profits accumulated since February 28, 1913, and is deductible as dividends paid.

Example (2). The M Corporation, a calendar year taxpayer, is completely liquidated on November 1, 1955, pursuant to a plan of liquidation adopted April 1, 1955. On January 1, 1955, the M Corporation has a deficit in earnings and profits of $100,000. During the period January 1, 1955, to the date of liquidation, November 1, 1955, it has earnings and profits of $10,000. The M Corporation is entitled to a dividends paid deduction in the amount of $10,000 as a result of its distribution in complete liquidation on November 1, 1955.

Example (3). The N Corporation, a calendar year taxpayer, is completely liquidated on July 1, 1958, pursuant to a plan of liquidation adopted February 1, 1955. No distributions in liquidation were made pursuant to the plan of liquidation adopted February 1, 1955, until the distribution in complete liquidation on July 1, 1958. On January 1, 1958, N Corporation had a deficit in earnings and profits of $30,000. During the period January 1, 1958, to the date of liquidation, on July 1, 1958, the N Corporation has earnings and profits of $5,000. The N Corporation is not entitled to any deduction for dividends paid as a result of the distribution in complete liquidation on July 1, 1958. If the earnings and profits for the period January 1, 1958, to July 1, 1958, had been $32,000, the N Corporation would have been entitled to a deduction for dividends paid in the amount of $2,000.

(c) *Special rule for personal holding companies.* Section 316 (b) (2) provides that in the case of a corporation which, under the law applicable to the taxable year in which a distribution is made, is a personal holding company, the term "dividend" (in addition to the general meaning set forth in section 316 (a)) also means a distribution to its shareholders to the extent of the corporation's undistributed personal holding company income (determined under section 545 without regard to such distributions) for the taxable year in which the distribution was made. See paragraph (b) of § 1.316–1.

§ 1.562–2 Preferential dividends.

(a) Section 562(c) imposes a limitation upon the general rule that a corporation is entitled to a deduction for dividends paid with respect to all dividends

which it actually pays during the taxable year. Before a corporation may be entitled to any such deduction with respect to a distribution regardless of the medium in which the distribution is made, every shareholder of the class of stock with respect to which the distribution is made must be treated the same as every other shareholder of that class, and no class of stock may be treated otherwise than in accordance with its dividend rights as a class. The limitation imposed by section 562(c) is unqualified, except in the case of an actual distribution made in connection with a consent distribution (see section 565), if the entire distribution composed of such actual distribution and consent distribution is not preferential. The existence of a preference is sufficient to prohibit the deduction regardless of the fact (1) that such preference is authorized by all the shareholders of the corporation or (2) that the part of the distribution received by the shareholder benefited by the preference is taxable to him as a dividend. A corporation will not be entitled to a deduction for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. Nor will a corporation be entitled to a deduction for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock. A preference exists if any rights to preference inherent in any class of stock are violated. The disallowance, where any preference in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution. As used in this section, the term "distribution" includes a dividend as defined in subchapter C, chapter 1 of the Code, and a distribution in liquidation referred to in section 562(b).

(b) The application of the provisions of section 562 (c) may be illustrated by the following examples:

Example (1). A, B, C, and D are the owners of all the shares of class A common stock in the M Corporation, which makes its income tax returns on a calendar year basis. With the consent of all the shareholders, the M Corporation on July 15, 1954, declared a dividend of $5 a share payable in cash on August 1, 1954, to A. On September 15, 1954, it declared a dividend of $5 a share payable in cash on October 1, 1954, to B, C, and D. No allowance for dividends paid for the taxable year 1954 is permitted to the M Corporation with respect to any part of the dividends paid on August 1, 1954, and October 1, 1954.

Example (2). The N Corporation, which makes its income tax returns on the calendar year basis, has a capital of $100,000 (consisting of 1,000 shares of common stock of a par value of $100) and earnings or profits accumulated after February 28, 1913, in the amount of $50,000. In the year 1954, the N Corporation distributes $7,500 in cancellation of 50 shares of the stock owned by three of the four shareholders of the corporation. No deduction for dividends paid is permissible under section 562 (c) and paragraph (a) of this section with respect to such distribution.

Example (3). The P Corporation has two classes of stock outstanding, 10 shares of cumulative preferred, owned by E, entitled to $5 per share and on which no dividends have been paid for two years, and 10 shares of common, owned by F. On December 31, 1954, the corporation distributes a dividend of $125, $50 to E, and $75 to F. The corporation is entitled to no deduction for any part of such dividend paid, since there has been a preference to F. If, however, the corporation had distributed $100 to E and $25 to F, it would have been entitled to include $125 as a dividend paid deduction.

§ 1.562–3 Distributions by a member of an affiliated group.

A personal holding company which files or is required to file a consolidated return with other members of an affiliated group may be required to file a separate personal holding company schedule by reason of the limitations and exceptions provided in section 542(b) and § 1.542–4. Section 562(d) provides that in such case the dividends paid deduction shall be allowed to the personal holding company, with respect to a distribution made to any member of the affiliated group, if such distribution would constitute a dividend if it were made to a shareholder which is not a member of the affiliated group.

§ 1.563 Statutory provisions; rules relating to dividends paid after close of taxable year.

SEC. 563. *Rules relating to dividends paid after close of taxable year*—(a) *Accumulated earnings tax.* In the determination of the dividends paid deduction for purposes of the accumulated earnings tax imposed by section 531, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall be considered as paid during such taxable year.

(b) *Personal holding company tax.* In the determination of the dividends paid deduction for purposes of the personal holding company tax imposed by section 541, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall, to the extent the taxpayer elects in its return for the taxable year, be considered as paid during such taxable year. The amount allowed as a dividend by reason of the application of this subsection with respect to any taxable year shall not exceed either—

(1) The undistributed personal holding company income of the corporation for the taxable year, computed without regard to this subsection, or

(2) 10 percent of the sum of the dividends paid during the taxable year, computed without regard to this subsection.

(c) *Dividends considered as paid on last day of taxable year.* For the purpose of applying section 562 (a), with respect to distributions under subsection (a) or (b) of this section, a distribution made after the close of a taxable year and on or before the 15th day of the third month following the close of the taxable year shall be considered as made on the last day of such taxable year.

§ 1.563–1 Accumulated earnings tax.

In the determination of the dividends paid deduction for purposes of the accumulated earnings tax imposed by section 531, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall be considered as paid during such taxable year, and shall not be included in the computation of the dividends paid deduction for the year of payment. However, the rule provided in section 563 (a) is not applicable to dividends paid during the first two and one-half months of the first taxable year of the corporation subject to tax under chapter 1 of the Internal Revenue Code of 1954.

§ 1.563–2 Personal holding company tax.

In the case of a personal holding company subject to the provisions of section 541 dividends paid after the close of the taxable year and before the 15th day of the third month thereafter shall be included in the computation of the dividends paid deduction for the taxable year only if the taxpayer so elects in its return for such taxable year. The election shall be made by including such dividends in computing its dividends paid deduction. The amount of such dividends which may be included in computing the dividends paid deduction for the taxable year shall not exceed either—

(a) The undistributed personal holding company income of the corporation for the taxable year, computed without regard to this section, or

(b) 10 percent of the sum of the dividends paid during the taxable year (not including consent dividends), computed without regard to this section.

In computing the amount of the dividends paid deduction allowable for any taxable year, the amount allowed by reason of section 563(b) for any preceding taxable year is considered a dividend paid in such preceding taxable year and not in the year of actual distribution. Thus, a double deduction is not allowable.

§ 1.563–3 Dividends considered as paid on last day of taxable year.

(a) *General rule.* Where a distribution made after the close of the taxable year is considered as paid during such taxable year, for purposes of applying section 562(a) the distribution shall be considered as made on the last day of such taxable year.

(b) *Personal holding company tax.* In the case of a corporation which under the law applicable to the taxable year in respect of which a distribution is made under section 563 (b) and § 1.563–2 is a personal holding company under the law applicable to such taxable year, section 316 (b) (2) provides that the term dividend means (in addition to the general rule under section 316 (a)) any distribution to the extent of the corporation's undistributed personal holding company income (determined under section 545 without regard to distributions under section 316 (b) (2)) for such year. See paragraph (b) of § 1.316–1.

(c) *Dividends paid on or before December 15, 1955.* The Act of June 15, 1955 (Public Law 74, 84th Cong., 69 Stat. 136), repealed sections 452 and 462 of the Code, relating to prepaid income and reserve for estimated expenses. Under section 4(c)(4) of that Act, dividends paid after the 15th day of the third month following the close of the taxable

year and on or before December 15, 1955, may be treated as having been paid on the last day of the taxable year for purposes of the accumulated earnings tax or the personal holding company tax and in the case of regulated investment companies, but only to the extent that such dividends are attributable to an increase in taxable income for the taxable year by reason of the repeal of sections 452 and 462. See paragraph (b) of § 1.9000–8, relating to treatment of certain dividends, prescribed pursuant to section 4(c)(4) of the Act of June 15, 1955.

§ 1.564 Statutory provisions; dividend carryover.

SEC. 564. *Dividend carryover*—(a) *General rule.* For purposes of computing the dividends paid deduction under section 561, in the case of a personal holding company the dividend carryover for any taxable year shall be the dividend carryover to such taxable year, computed as provided in subsection (b), from the two preceding taxable years.

(b) *Computation of dividend carryover.* The dividend carryover to the taxable year shall be determined as follows:

(1) For each of the 2 preceding taxable years there shall be determined the taxable income computed with the adjustments provided in section 545 (whether or not the taxpayer was a personal holding company for either of such preceding taxable years), and there shall also be determined for each such year the deduction for dividends paid during such year as provided in section 561 (but determined without regard to the dividend carryover to such year).

(2) There shall be determined for each such taxable year whether there is an excess of such taxable income over such deduction for dividends paid or an excess of such deduction for dividends paid over such taxable income, and the amount of each such excess.

(3) If there is an excess of such deductions for dividends paid over such taxable income for the first preceding taxable year, such excess shall be allowed as a dividend carryover to the taxable year.

(4) If there is an excess of such deduction for dividends paid over such taxable income for the second preceding taxable year, such excess shall be reduced by the amount determined in paragraph (5), and the remainder of such excess shall be allowed as a dividend carryover to the taxable year.

(5) The amount of the reduction specified in paragraph (4) shall be the amount of the excess of the taxable income, if any, for the first preceding taxable year over such deduction for dividends paid, if any, for the first preceding taxable year.

(c) *Determination of dividend carryover from taxable years to which this subtitle does not apply.* In a case where the first or second preceding taxable year began before the taxpayer's first taxable year under this subtitle, the amount of the dividend carryover to taxable years to which this subtitle applies shall be determined under the provisions of the Internal Revenue Code of 1939.

§ 1.564–1 Dividend carryover.

(a) *General rule.* The dividend carryover from the two preceding years, allowable only to personal holding companies, is includible in the dividends paid deduction under section 561. It is computed as follows:

(1) If, for each of the preceding two years, the deduction for dividends paid under section 561 (determined without regard to the dividend carryover to each such year) exceeds the taxable income (adjusted as provided in section 545 for purposes of determining undistributed personal holding company income) then the dividend carryover to the taxable year is the sum of both such excess amounts.

(2) If the deduction for dividends paid under section 561 for the second preceding year (determined without regard to the dividend carryover to such year) exceeds the taxable income for such year (adjusted as provided in section 545), and if the taxable income for the first preceding year (as so adjusted) exceeds the dividends paid deduction for such first preceding year (as so determined), then the dividend carryover to the taxable year shall be such excess amount for the second preceding year, less such excess amount for the first preceding year.

(3) If for the first preceding year the deduction for dividends paid under section 561 (determined without regard to the dividend carryover to such year) exceeds the taxable income (adjusted as provided in section 545) for such year, and such excess is not present in the second preceding year, then the dividend carryover to the taxable year shall be such excess amount for the first preceding year.

(b) *Dividend carryover from year in which taxpayer was not a personal holding company.* In computing the dividend carryover, the taxable income as adjusted under section 545 of any preceding taxable year shall be determined as if the corporation was, under the law applicable to such taxable year, a personal holding company.

(c) *Dividend carryover from year in which taxpayer was subject to 1939 Code.* In a case where the first or the second preceding taxable year began before the taxpayer's first taxable year under the Internal Revenue Code of 1954, the amount of the dividend carryover shall be determined under the Internal Revenue Code of 1939.

(d) *Statement to be filed with return.* Every corporation claiming a dividend carryover for any taxable year shall file with its return for such year a concise statement setting forth the amount of the dividend carryover claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the dividend carryover claimed.

(e) *Computation of dividend carryover.* The computation of the dividend carryover may be illustrated by the following examples:

Example (1). The X Corporation, which files its income tax returns on the calendar year basis, has taxable income, adjusted as required by section 545, in the amount of $110,000 and has a dividends paid deduction of $150,000 for the year 1954. For 1955, its taxable income, adjusted as required by section 545, is $200,000 and its dividends paid deduction is $300,000. The dividend carryover to the year 1956 is $140,000, computed as follows:

Dividends paid deduction for 1954	$150,000
Taxable income for 1954	110,000
Dividend carryover from 1954	40,000
Dividends paid deduction for 1955	300,000
Taxable income for 1955	200,000
Dividend carryover from 1955	100,000
Dividend carryover for 2 preceding taxable years, allowable as a deduction for the year 1956	140,000

Example (2). The Y Corporation, which files its income tax returns on the calendar year basis, has taxable income, adjusted as required by section 545, in the amount of $100,000 and has a dividends paid deduction of $150,000 for the year 1954. For 1955, its taxable income, adjusted as required by section 545, is $200,000 and its dividends paid deduction is $170,000. The dividend carryover to the year 1956 is $20,00 computed as follows:

Dividends paid deduction for 1954	$150,000
Taxable income for 1954	100,000
Dividend carryover from 1954	50,000
Taxable income for 1955	200,000
Dividends paid deduction for 1955	170,000
Excess of taxable income over dividends paid deduction	30,000
Dividend carryover for second preceding taxable year, allowable as a deduction for the year 1956	20,000

§ 1.565 Statutory provisions; consent dividends.

SEC. 565. *Consent dividends*—(a) *General rule.* If any person owns consent stock (as defined in subsection (f) (1)) in a corporation on the last day of the taxable year of such corporation, and such person agrees, in a consent filed with the return of such corporation in accordance with regulations prescribed by the Secretary or his delegate, to treat as a dividend the amount specified in such consent, the amount so specified shall, except as provided in subsection (b), constitute a consent dividend for purposes of section 561 (relating to the deduction for dividends paid).

(b) *Limitations.* A consent dividend shall not include—

(1) An amount specified in a consent which, if distributed in money, would constitute, or be part of, a distribution which would be disqualified for purposes of the dividends paid deduction under section 562 (c) (relating to preferential dividends), or

(2) An amount specified in a consent which would not constitute a dividend (as defined in section 316) if the total amounts specified in consents filed by the corporation had been distributed in money to shareholders on the last day of the taxable year of such corporation.

(c) *Effect of consent.* The amount of a consent dividend shall be considered, for purposes of this title—

(1) As distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation, and

(2) As contributed to the capital of the corporation by the shareholder on such day.

(d) *Consent dividends and other distributions.* If a distribution by a corporation consists in part of consent dividends and in part of money or other property, the entire amount specified in the consents and the amount of such money or other property shall be considered together for purposes of applying this title.

(e) *Nonresident aliens and foreign corporations.* In the case of a consent dividend which, if paid in money would be subject to the provisions of section 1441 (relating to withholding of tax on nonresident aliens) or

section 1442 (relating to withholding of tax on foreign corporations), this section shall not apply unless the consent is accompanied by money, or such other medium of payment as the Secretary or his delegate may by regulations authorize, in an amount equal to the amount that would be required to be deducted and withheld under sections 1441 or 1442 if the consent dividend had been, on the last day of the taxable year of the corporation, paid to the shareholder in money as a dividend. The amount accompanying the consent shall be credited against the tax imposed by this subtitle on the shareholder.

(f) *Definitions*—(1) *Consent stock.* Consent stock, for purposes of this section, means the class or classes of stock entitled, after the payment of preferred dividends, to a share in the distribution (other than in complete or partial liquidation) within the taxable year of all the remaining earnings and profits, which share constitutes the same proportion of such distribution regardless of the amount of such distribution.

(2) *Preferred dividends.* Preferred dividends, for purposes of this section, means a distribution (other than in complete or partial liquidation), limited in amount, which must be made on any class of stock before a further distribution (other than in complete or partial liquidation) of earnings and profits may be made within the taxable year.

§ 1.565–1 General rule.

(a) *Consent dividends.* The dividends paid deduction, as defined in section 561, includes the consent dividends for the taxable year. A consent dividend is a hypothetical distribution (as distinguished from an actual distribution) which any person, who owns consent stock on the last day of the taxable year of the corporation, agrees to treat as a dividend subject to the limitations in section 565(b) and § 1.565–2. The amount of the distribution must be specified by such person in a consent (or consents) filed at the time and in the manner specified in paragraph (b) of this section.

(b) *Making and filing of consents.* (1) A consent shall be made on Form 972 in accordance with this section and the instructions on the form issued therewith. It may be made only by or on behalf of a person who was the actual owner on the last day of the corporation's taxable year of any class of consent stock, that is, the person who would have been required to include in gross income any dividends on such stock actually distributed on the last day of such year. Form 972 shall contain or be verified by a written declaration that it is made under the penalties of perjury. In the consent such person must agree to include in his gross income for his taxable year in which or with which the taxable year of the corporation ends a specific amount as a taxable dividend.

(2) See § 1.565–2 for rules as to when all or a portion of the amount so specified will be disregarded for tax purposes.

(3) A consent may be filed at any time not later than the due date of the corporation's income tax return for the taxable year for which the dividends paid deduction is claimed. With such return, and not later than the due date thereof, the corporation must file Forms 972 duly executed by each consenting shareholder, and a return on Form 973 showing by classes the stock outstanding on the first and last days of the taxable year, the dividend rights of such stock, distributions made during the taxable year to shareholders, and giving all the other information required by the form. Form 973 shall contain or be verified by a written declaration that it is made under the penalties of perjury.

(c) *Taxability of amounts specified in consents.* (1) Once a shareholder's consent is filed, the full amount specified therein shall be included in his gross income as a taxable dividend, except as otherwise provided in section 565 (b) and § 1.565–2. Where the shareholder is taxable on a dividend only if received from sources within the United States, the amount specified in the consent of such shareholder shall be treated as a dividend from such sources in the same manner as if the dividend had been paid in money to the shareholder on the last day of the corporation's taxable year. See paragraph (b) of this section, relating to the making and filing of consents, and section 565 (e) and § 1.565–5, with respect to the payment requirements in the case of nonresident aliens and foreign corporations.

(2) Except as provided in section 565 (b) and § 1.565–2, the ground upon which a consent dividends deduction is denied the corporation does not affect the taxability of a shareholder whose consent has been filed for the amount specified in his consent. Thus, he is taxable on the full amount so specified even though a consent dividends deduction may be denied the corporation or may be of less value to it because, for example, (i) it is determined that it is not a corporation subject to part I, II, or III, subchapter G, chapter 1 of the Code, (ii) although subject to part II, subchapter G, chapter 1 of the Code, its taxable income (as adjusted under section 545(b) and § 1.545–2) is less than the total of the consent dividends, or (iii) in the case of nonresident aliens or foreign corporations, payment has not been made as required by section 565 (e) and § 1.565–5.

§ 1.565–2 Limitations.

(a) Amounts specified in consents are not treated as consent dividends to the extent that they would constitute a preferential dividend, or would not constitute a dividend (as defined in section 316), if distributed in money to shareholders on the last day of the taxable year of the corporation. If any portion of an amount specified in a consent is not treated as a consent dividend under section 565(b) and this section, it is disregarded for all tax purposes. For example, it is not taxable to the consenting shareholder, and paragraph (c) of § 1.565–1 is not applicable to such portion of the amount specified in the consent.

(b) (1) A preferential distribution is an actual distribution, or a consent distribution, or a combination of the two, which involves a preference to one or more shares of stock as compared with other shares of the same class or to one class of stock as compared with any other class of stock. See section 562 (c) and § 1.562–2.

(2) The application of section 565 (b) (1) may be illustrated by the following examples:

Example (1). The X Corporation, which makes its income tax returns on the calendar year basis, has 200 shares of stock outstanding, owned by A and B in equal amounts. On December 15, 1954, the corporation distributes $600 to B and $100 to A. As a part of the same distribution A executes a consent to include $500 in his gross income as a taxable dividend though such amount is not distributed to him. The X Corporation, assuming the other requirements of section 565 have been complied with, is entitled to a consent dividends deduction of $500. Although the consent dividend is deemed to have been paid on December 31, 1954, the last day of the taxable year of the corporation, they constitute a single nonpreferential distribution of $1,200.

Example (2). The Y Corporation, which makes its income tax returns on the calendar year basis, has one class of consent stock outstanding, owned in equal amounts by A, B, and C. On December 15, 1954, the corporation makes a distribution in cash of $5,000 each to A and B, and $3,000 to C. The distribution is preferential. If A and B each receive a distribution in cash of $5,000 and C consents to include $3,000 in gross income as a taxable dividend, the combined actual and consent distribution is preferential. Similarly, if no one receives a distribution in cash, but A and B each consents to include $5,000 as a taxable dividend in gross income and C agrees to include only $3,000, the consent distribution is preferential.

Example (3). The Z Corporation, which makes its income tax returns on the calendar year basis, has only two classes of stock outstanding, each class being consent stock and consisting of 500 shares. Class A, with a par value of $40 per share, is entitled to two-thirds of any distribution of earnings and profits. Class B, with a par value of $20 per share, is entitled to one-third of any distribution of earnings and profits. On December 15, 1954, there is distributed on the class B stock $2 per share, or $1,000, and shareholders of the class A stock consent to include in gross income amounts equal to $2 per share, or $1,000. The distribution is preferential, inasmuch as the class B stock has received more than its pro rata share of the combined amounts of the actual distributions and the consent distributions.

(c) (1) An additional limitation under section 565 (b) is that the amounts specified in consents which may be treated as consent dividends cannot exceed the amounts which would constitute a dividend (as defined in section 316) if the corporation had distributed the total specified amounts in money to shareholders on the last day of the taxable year of the corporation. If only a portion of such total would constitute a dividend, then only a corresponding portion of each specified amount is treated as a consent dividend.

(2) The application of section 565 (b) (2) may be illustrated by the following example:

Example. The X Corporation, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year 1954. Its earnings and profits for the calendar year 1954 amount to $8,000, there being at the beginning of such year no accumulated earnings or profits. A and B execute proper consents to include $5,000 each in their gross income as a dividend received by them on December 31, 1954. The

sum of the amount specified in the consents executed by A and B is $10,000, but if $10,000 had actually been distributed by the X Corporation on December 31, 1954, only $8,000 would have constituted a dividend under section 316 (a). The amount which could be considered as consent dividends in computing the dividends paid deduction for purposes of the accumulated earnings tax is limited to $8,000, or $4,000 of the $5,000 specified in each consent. The remaining $1,000 in each consent is disregarded for all tax purposes. In the case of a personal holding company, the amount which could be considered as consent dividends in computing the dividends paid deduction for purposes of the personal holding company tax is $10,000 (assuming that the undistributed personal holding company income, determined without regard to distributions under section 316 (b) (2), is equal to at least that amount). In that event, A and B would each include $5,000 in gross income as a dividend received on December 31, 1954.

§ 1.565–3 Effect of consent.

(a) The amount of the consent dividend shall be considered, for all purposes of the Code, as if it were distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation, received by the shareholder on such day, and immediately contributed by the shareholder as paid-in capital to the corporation on such day. Thus, the amount of the consent dividend will be treated by the shareholder as a dividend. The shareholder will be entitled to the dividends received credit under section 34 and the exclusion under section 116, or to the dividends received deduction under section 243, with respect to such consent dividend. The basis of the shareholder's consent stock in a corporation will be increased by the amount thus treated in his hands as a dividend which he is considered as having contributed to the corporation as paid-in capital. The amount of the consent dividend will also be treated as a dividend received from sources within the United States in the same manner as if the dividend had been paid in money to the shareholders. Among other effects of the consent dividend, the earnings and profits of the corporation will be decreased by the amount of the consent dividends. Moreover, if the shareholder is a corporation, its accumulated earnings and profits will be increased by the amount of the consent dividend with respect to which it makes a consent.

(b) The application of section 565 (c) to a corporate shareholder may be illustrated by the following examples:

Example (1). The A Corporation has one shareholder, the B Corporation, whose consent to include $10,000 in its gross income for the calendar year 1954 has been duly made and filed. The earnings and profits of the A Corporation for the calendar year 1954 amount to only $8,000, there being at the beginning of such year no accumulated earnings or profits. If A Corporation was a personal holding company for 1954 and had undistributed personal holding company income for that year of $10,000 or more (determined without regard to distributions under section 316 (b) (2)) the B Corporation must include $10,000 in its gross income as a taxable dividend. On the other hand, if A was not a personal holding company for 1954, the B Corporation must include in its gross income $8,000 as a taxable dividend.

Example (2). Assume the B Corporation to have begun the year 1954 with $5,000 accumulated earnings and profits, to have made no distributions during the year, and to have had neither profit nor loss from operations during the year 1954. If the A Corporation was a personal holding company for 1954, the amount of $10,000 included in the income of the B Corporation shall be considered as earnings and profits for the year 1954 and the earnings and profits of B Corporation at the close of such year will include both the $5,000 accumulated earnings and profits and the $10,000 included in income. But if A Corporation was not a personal holding company for 1954, the amount of $8,000 included in the income of the B Corporation shall be considered as earnings and profits for the year 1954 and the earnings and profits of B Corporation at the close of such year will include both the $5,000 accumulated earnings and profits and the $8,000 included in income.

§ 1.565–4 Consent dividends and other distributions.

Section 565(d) provides a rule applicable where a distribution is made in part in consent dividends and in part in money or other property. With respect to such a distribution the entire amount specified in the consents and the amount of such money or other property shall be considered together. Thus, if as a part of the same distribution consents are filed by some of the shareholders and cash is distributed to other shareholders, for example, those who may be unwilling to sign consents, the total amount of the cash and the amounts specified in the consents will be viewed as a single distribution to determine the tax effects of such distribution. For example, the total of such amounts must be considered to determine whether the distribution (including the amounts specified in the consents) is preferential and whether any part of such distribution would not be dividends if the total amounts specified in the consents were distributed in cash. See paragraph (b) (2) of § 1.565–2 for examples illustrating the treatment of distributions which consist in part of consent dividends and in part of other property.

§ 1.565–5 Nonresident aliens and foreign corporations.

In the event that any consent filed by the corporation is made by a shareholder to whom the payment of a dividend in cash on the last day of the taxable year of the corporation would have made it necessary for the corporation to deduct and withhold any amount as a tax under section 1441 or section 1442, such consent, when filed by the corporation, must be accompanied by payment of the amount which would have been required to be deducted and withheld if the amount specified in such consent had, on the last day of the corporation's taxable year, been paid to the shareholder in cash as a dividend. Such payment must be in one of the following forms:

(a) Cash;

(b) United States postal money order;

(c) Certified check drawn on a domestic bank, provided that the law of the place where the bank is located does not permit the certification to be rescinded prior to presentation;

(d) A cashier's check of a domestic bank, or

(e) A draft on a domestic bank or a foreign bank maintaining a United States agency or branch and payable in United States funds.

The amount of such payment shall be credited against the tax imposed on the shareholder.

§ 1.565–6 Definitions.

(a) *Consent stock.* (1) The term "consent stock" includes what is generally known as common stock. It also includes participating preferred stock, the participation rights of which are unlimited.

(2) The definition of consent stock may be illustrated by the following example:

Example. If in the case of the X Corporation there is only one class of stock outstanding, it would all be consent stock. If, on the other hand, there were two classes of stock, class A and class B, and class A was entitled to 6 percent before any distribution could be made on class B, but class B was entitled to everything distributed after class A had received its 6 percent, only class B stock would be consent stock. Similarly, if class A, after receiving its 6 percent, was to participate equally or in some fixed proportion with class B until it had received a second 6 percent, after which class B alone was entitled to any further distributions, only class B stock would be consent stock. The same result would follow if the order of preferences were class A 6 percent, then class B 6 percent, then class A a second 6 percent, either alone or in conjunction with class B, then class B the remainder. If, however, class A stock is entitled to ultimate participation without limit as to amount, then it, too, may be consent stock. For example, if class A is to receive 3 percent and then share equally or in some fixed proportion with class B in the remainder of the earnings or profits distributed, both class A stock and class B stock are consent stock.

(b) *Preferred dividends.* (1) The term "preferred dividends" includes all fixed amounts (whether determined by percentage of par value, a stated return expressed in a certain number of dollars per share, or otherwise) the distribution of which on any class of stock is a condition precedent to a further distribution of earnings or profits (not including a distribution in partial or complete liquidation). A distribution, though expressed in terms of a fixed amount, is not a preferred dividend, however, unless it is preferred over a subsequent distribution within the taxable year upon some class or classes of stock other than one on which it is payable.

(2) The definition of preferred dividends may be illustrated by the following example:

Example. If, in the case of the X Corporation, there are only two classes of stock outstanding, class A and class B, and class A is entitled to a distribution of 6 percent of par, after which the balance of the earnings and profits are distributable on class B exclusively, class A's 6 percent is a preferred dividend. If the order of preferences is class A $6 per share, class B $6 per share, then class A and class B in fixed proportions until class A receives $3 more per share, then class B the remainder, all of class A's $9 per share

and $6 per share of the amount distributable on class B are preferred dividends. The amount which class B is entitled to receive in conjunction with the payment to class A of its last $8 per share is not a preferred dividend, because the payment of such amount is preferred over no subsequent distribution except one made on class B itself. Finally, if a distribution must be $6 on class A, $6 on class B, then on class A and class B share and share alike, the distribution on class A of $6 and the distribution on class B of $6 are both preferred dividends.

BANKING INSTITUTIONS

RULES OF GENERAL APPLICATION TO BANKING INSTITUTIONS

§ 1.581 Statutory provisions; definition of bank.

SEC. 581. *Definition of bank.* For purposes of sections 582 and 584, the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11 (k) of the Federal Reserve Act (38 Stat. 262; 12 U. S. C. 248 (k)), and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

§ 1.581–1 Tax on banks.

A bank, as defined in section 581, is subject to the tax on corporations imposed by section 11.

§ 1.581–2 Mutual savings banks, building and loan associations, and cooperative banks.

(a) Mutual savings banks, building and loan associations, and cooperative banks not having capital stock represented by shares are subject to tax as in the case of other corporations. For special rules governing the taxation of a mutual savings bank conducting a life insurance business, see section 594 and § 1.594–1.

(b) While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, and a cooperative bank not having capital stock represented by shares, there are certain exceptions and special rules governing the computation in the case of such institutions. See section 593 and § 1.593–1 for special rules concerning additions to reserves for bad debts. See section 591 and § 1.591–1, relating to dividends paid by banking corporations, for special rules concerning deductions for amounts paid to, or credited to the accounts of, depositors or holders of withdrawable accounts as dividends. See also section 592 and § 1.592–1, relating to deductions for repayment of certain loans.

(c) For the purpose of computing the net operating loss deduction provided in section 172, any taxable year for which a mutual savings bank, building and loan association, or a cooperative bank not having capital stock represented by shares was exempt from tax shall be disregarded. Thus, no net operating loss carryover shall be allowed from a taxable year beginning before January 1, 1952, and, in the case of any taxable year beginning after December 31, 1951, the amount of the net operating loss carryback or carryover from such year shall not be reduced by reference to the income of any taxable year beginning before January 1, 1952.

§ 1.582 Statutory provisions; bad debt and loss deduction with respect to securities held by banks.

SEC. 582. *Bad debt and loss deduction with respect to securities held by banks*—(a) *Securities.* Notwithstanding sections 165 (g) (1) and 166 (e), subsections (a), (b), and (c) of section 166 (relating to allowance of deduction for bad debts) shall apply in the case of a bank to a debt which is evidenced by a security as defined in section 165 (g) (2) (C).

(b) *Worthless stock in affiliated bank.* For purposes of section 165(g)(1), where the taxpayer is a bank and owns directly at least 80 percent of each class of stock of another bank, stock in such other bank shall not be treated as a capital asset.

(c) *Bond, etc., losses of banks.* For purposes of this subtitle, in the case of a bank, if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof, exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset.

[Sec. 582 as amended by sec. 34, Technical Amendments Act 1958 (72 Stat. 1632)]

§ 1.582–1 Bad debt and loss deduction with respect to securities held by banks.

(a) A bank, as defined in section 581, is allowed a deduction for bad debts to the extent and in the manner provided by subsections (a), (b), and (c) of section 166 with respect to a debt which has become worthless in whole or in part and which is evidenced by a security (a bond, debenture, note, certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money) issued by any corporation (including governments and their political subdivisions), with interest coupons or in registered form.

(b) For purposes of section 165 (g) (1), relating to the deduction for losses involving worthless securities, if the taxpayer is a bank (as defined in section 581) and owns directly at least 80 percent of each class of stock of another bank, stock in such other bank shall not be treated as a capital asset.

(c) With respect to the taxation under subtitle A of the Code of a bank (as defined in section 581), if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof), exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset.

§ 1.583 Statutory provisions; deductions of dividends paid on certain preferred stock.

SEC. 583. *Deductions of dividends paid on certain preferred stock.* In computing the taxable income of any national banking association, or of any bank or trust company organized under the laws of any State, Territory, possession of the United States, or the Canal Zone, or of any other banking corporation engaged in the business of industrial banking and under the supervision of a State banking department or of the Comptroller of the Currency, or of any incorporated domestic insurance company, there shall be allowed as a deduction from gross income, in addition to deductions otherwise provided for in this subtitle, any dividend (not including any distribution in liquidation) paid, within the taxable year, to the United States or to any instrumentality thereof exempt from Federal income taxes, on the preferred stock of the corporation owned by the United States or such instrumentality. The amount allowable as a deduction under this section shall reduce the deduction for dividends paid otherwise computed under section 561.

§ 1.584 Statutory provisions; common trust funds.

SEC. 584. *Common trust funds*—(a) *Definitions.* For purposes of this subtitle, the term "common trust fund" means a fund maintained by a bank—

(1) Exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian; and

(2) In conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System pertaining to the collective investment of trust funds by national banks.

(b) *Taxation of common trust funds.* A common trust fund shall not be subject to taxation under this chapter and for purposes of this chapter shall not be considered a corporation.

(c) *Income of participants in fund*—(1) *Inclusions in taxable income.* Each participant in the common trust fund in computing its taxable income shall include, whether or not distributed and whether or not distributable—

(A) As part of its gains and losses from sales or exchanges of capital assets held for not more than 6 months, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for not more than 6 months;

(B) As part of its gains and losses from sales or exchanges of capital assets held for more than 6 months, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for more than 6 months;

(C) Its proportionate share of the ordinary taxable income or the ordinary net loss of the common trust fund, computed as provided in subsection (d).

(2) *Dividends and partially tax exempt interest.* The proportionate share of each participant in the amount of dividends to which section 34 or section 116 applies, and in the amount of partially tax exempt interest on obligations described in section 35 or section 242, received by the common trust fund shall be considered for purposes of such sections as having been received by such participant. If the common trust fund elects under section 171 (relating to amortizable bond premium) to amortize the premium on such obligations, for purposes of the preceding sentence the proportionate share of the participant of such interest received by the common trust fund shall be his proportionate share of such interest (determined with-

out regard to this sentence) reduced by so much of the deduction under section 171 as is attributable to such share.

(d) *Computation of common trust fund income.* The taxable income of a common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(1) There shall be segregated the gains and losses from sales or exchanges of capital assets;

(2) After excluding all items of gain and loss from sales or exchanges of capital assets, there shall be computed—

(A) An ordinary taxable income which shall consist of the excess of the gross income over deductions; or

(B) An ordinary net loss which shall consist of the excess of the deductions over the gross income;

(3) The deduction provided by section 170 (relating to charitable, etc., contributions and gifts) shall not be allowed; and

(4) The standard deduction provided in section 141 shall not be allowed.

(e) *Admission and withdrawal.* No gain or loss shall be realized by the common trust fund by the admission or withdrawal of a participant. The withdrawal of any participating interest by a participant shall be treated as a sale or exchange of such interest by the participant.

(f) *Different taxable years of common trust fund and participant.* If the taxable year of the common trust fund is different from that of a participant, the inclusions with respect to the taxable income of the common trust fund, in computing the taxable income of the participant for its taxable year, shall be based upon the taxable income of the common trust fund for any taxable year of the common trust fund ending within or with the taxable year of the participant.

(g) *Net operating loss deduction.* The benefit of the deduction for net operating losses provided by section 172 shall not be allowed to a common trust fund, but shall be allowed to the participants in the common trust fund under regulations prescribed by the Secretary or his delegate.

§ 1.584–1 Common trust funds.

(a) *Method of taxation.* A common trust fund maintained by a bank is not subject to taxation under this chapter and is not considered a corporation. Its participants are taxed on their proportionate share of income from the common trust fund. Except as otherwise provided in §§ 1.584–1 to 1.584–6, inclusive, the term "participant" refers to any trust or estate, the moneys of which have been contributed to the common trust fund.

(b) *Conditions for qualification.* Under section 584, two conditions must be satisfied by a fund maintained by a bank (as defined in section 581) before such fund may be designated as a "common trust fund." These conditions are that such fund must be maintained by such a bank:

(1) Exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank, whether acting alone or in conjunction with one or more co-fiduciaries, but solely in its capacity: (i) As a trustee of a trust created by will, deed, agreement, declaration of trust, or order of court, (ii) as an executor of the will of, or as an administrator of the estate of, a deceased person, or (iii) as a guardian (by whatever name known under local law) of the estate of an infant, of an incompetent individual, or of an absent individual; and

(2) In conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System pertaining to the collective investment of trust funds by national banks, whether or not the bank maintaining such fund is a national bank or a member of the Federal Reserve System.

§ 1.584–2 Income of participants in common trust fund.

(a) Each participant in a common trust fund is required to include in computing its taxable income for its taxable year within which or with which the taxable year of the fund ends, whether or not distributed and whether or not distributable:

(1) Its proportionate share of the gains and losses from sales or exchanges of capital assets held for not more than six months, computed as provided in § 1.584–3, as part of its gains and losses from sales or exchanges of capital assets held for not more than six months;

(2) Its proportionate share of the gains and losses from sales or exchanges of capital assets held for more than six months, computed as provided in § 1.584–3, as part of its gains and losses from sales or exchanges of capital assets held for more than six months; and

(3) Its proportionate share of the ordinary taxable income or the ordinary net loss of the common trust fund, computed as provided in § 1.584–3.

(b) (1) Each participant's proportionate share in the amount of dividends to which section 34 or section 116 applies received by the common trust fund shall be deemed to have been received by such participant as such dividends.

(2) Each participant's proportionate share in the amount of partially tax exempt interest described in section 35 or section 242 received by the common trust fund shall be deemed to have been received by such participant as such interest. If the common trust fund elects under section 171 (relating to amortizable bond premium) to amortize the premium on such obligations, for purposes of the preceding sentence the proportionate share of each participant of such interest received by the fund shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 171 as is attributable to such share. See section 171 and the regulations thereunder.

(3) Any tax withheld at the source from income of the fund shall be deemed to have been withheld proportionately from the participants to whom such income is allocated.

(c) (1) The proportionate share of each participant in gains and losses from sales or exchanges of capital assets held for not more than six months, gains and losses from sales or exchanges of capital assets held for more than six months, ordinary taxable income or ordinary net loss, dividends received, partially exempt interest, and tax withheld at the source shall be determined under the method of accounting adopted by the bank in accordance with the written plan under which the common trust fund is established and administered, provided such method clearly reflects the income of each participant.

(2) The items of income and deductions are, therefore, to be allocated to the periods between valuation dates within the taxable year established by such plan in which they were realized or sustained, and the ordinary taxable income or ordinary net loss, gains and losses from sales or exchanges of capital assets held for not more than six months, and gains and losses from sales or exchanges of capital assets held for more than six months computed for each such period. The proportionate shares of the participants in such items are then to be determined.

(3) The provisions of subparagraph (2) of this paragraph may be illustrated by the following example:

Example. (i) The plan of a common trust fund provides for quarterly valuation dates and for the computation and the distribution of the income upon a quarterly basis, except that there shall be no distribution of capital gains. The participants are as follows: Trusts A, B, C, and D for the first quarter; Trusts A, B, C, and E for the second quarter; and Trusts A, B, F, and G for the third and fourth quarters, the participants having equal participating interests. As computed upon the quarterly basis, the ordinary taxable income, the short-term capital gain, and the long-term capital loss for the taxable year were as follows:

	First quarter	Second quarter	Third quarter	Fourth quarter	Total
Ordinary taxable income	$200	$300	$200	$400	$1,100
Short-term capital gain	200	100	200	100	600
Long-term capital loss	100	200	100	200	600

(ii) The participants' shares of ordinary taxable income are as follows:

PARTICIPANTS' SHARES OF ORDINARY TAXABLE INCOME

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$75	$50	$100	$275
B	50	75	50	100	275
C	50	75	-------	-------	125
D	50	-------	-------	-------	50
E	-------	75	-------	-------	75
F	-------	-------	50	100	150
G	-------	-------	50	100	150
Total	200	300	200	400	1,100

(iii) The participants' shares of the short-term capital gain are as follows:

PARTICIPANTS' SHARES OF SHORT-TERM CAPITAL GAIN

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$25	$50	$25	$150
B	50	25	50	25	150
C	50	25	-------	-------	75
D	50	-------	-------	-------	50
E	-------	25	-------	-------	25
F	-------	-------	50	25	75
G	-------	-------	50	25	75
Total	200	100	200	100	600

(iv) The participants' shares of the long-term capital loss are as follows:

PARTICIPANTS' SHARES OF LONG-TERM CAPITAL LOSS

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$25	$50	$25	$50	$150
B	25	50	25	50	150
C	25	50	------	------	75
D	25	------	------	------	25
E	------	50	------	------	50
F	------	------	25	50	75
G	------	------	25	50	75
Total	100	200	100	200	600

(4) If in the above example the common trust fund also had short-term capital losses and long-term capital gains, the treatment of such gains or losses would be similar to that accorded to the short-term capital gains and long-term capital losses in the above example.

(d) The provisions of subparts A, B, C, D, and E, part I, subchapter J, chapter 1 of the Code, are applicable in determining the extent to which each participant's proportionate share of the income of the common trust fund is taxable to the participant, or to the beneficiaries or the grantor of the participant.

§ 1.584–3 Computation of common trust fund income.

The taxable income of the common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that:

(a) No deduction shall be allowed under section 170 (relating to charitable, etc., contributions and gifts);

(b) The gains and losses from sales or exchanges of capital assets of the common trust fund are required to be segregated. A common trust fund is not allowed the benefit of the capital loss carryover provided by section 1212;

(c) The ordinary taxable income (the excess of the gross income over deductions) or the ordinary net loss (the excess of the deductions over the gross income) shall be computed after excluding all items of gain and loss from sales or exchanges of capital assets; and

(d) The standard deduction provided in section 141 shall not be allowed.

§ 1.584–4 Admission and withdrawal of participants in the common trust fund.

(a) *Gain or loss.* The common trust fund realizes no gain or loss by the admission or withdrawal of a participant, and the basis of the assets and the period for which they are deemed to have been held by the common trust fund for the purposes of section 1202 are unaffected by such an admission or withdrawal. If a participant withdraws the whole or any part of its participating interest from the common trust fund, such withdrawal shall be treated as a sale or exchange by the participant of the participating interest or portion thereof which is so withdrawn. A participant is not deemed to have withdrawn any part of its participating interest in the common trust fund so as to have completed a closed transaction by reason of the segregation and administration of an investment of the fund, pursuant to the provisions of 12 CFR 206.17(c)(7) (Regulation F of the Board of Governors of the Federal Reserve System, as amended), for the benefit of all the then participants in the common trust fund. Such segregated investment shall be considered as held by, or on behalf of, the common trust fund for the benefit ratably of all participants in the common trust fund at the time of segregation, and any income or loss arising from its administration and liquidation shall constitute income or loss to the common trust fund apportionable among the participants for whose benefit the investment was segregated.

(b) *Basis for gain or loss upon withdrawal.* The participant's gain or loss upon withdrawal of its participating interest or portion thereof shall be measured by the difference between the amount received upon such withdrawal and the adjusted basis of the participating interest or portion thereof withdrawn plus the additions prescribed in paragraph (c) of this section and minus the reductions prescribed in paragraph (d) of this section. The amount received by the participant shall be the sum of any money plus the fair market value of property (other than money) received upon such withdrawal. The basis of the participating interest or portion thereof withdrawn shall be the sum of any money plus the fair market value of any property (other than money) contributed by the participant to the common trust fund to acquire the participating interest or portion thereof withdrawn. Such basis shall not be reduced on account of the segregation of any investment in the common trust fund pursuant to the provisions of 12 CFR 206.17(c)(7) (Regulation F of the Board of Governors of the Federal Reserve System, as amended). For the purpose of making the adjustments, additions, and reductions with respect to basis as prescribed in this paragraph, the ward, rather than the guardian, shall be deemed to be the participant; and the grantor, rather than the trust, shall be deemed to be the participant, to the extent that the income of the trust is taxable to the grantor under subpart E, part I, subchapter J, chapter 1 of the Code.

(c) *Additions to basis.* As prescribed in paragraph (b) of this section, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, there shall be added to the basis of the participating interest or portion thereof withdrawn an amount equal to the aggregate of the following items (to the extent that they were properly allocated to the participant for a taxable year of the common trust fund and were not distributed to the participant prior to withdrawal):

(1) Wholly exempt income of the common trust fund for any taxable year,

(2) Net income of the common trust fund for the taxable years beginning after December 31, 1935, and prior to January 1, 1938,

(3) Net short-term capital gain of the common trust fund for each taxable year beginning after December 31, 1937,

(4) The excess of the gains over the losses recognized to the common trust fund upon sales or exchanges of capital assets held (i) for more than 18 months for taxable years beginning after December 31, 1937, and before January 1, 1942, and (ii) for more than 6 months for taxable years beginning after December 31, 1941, and

(5) Ordinary net or taxable income of the common trust fund for each taxable year beginning after December 31, 1937.

(d) *Reductions in basis.* As prescribed in paragraph (b) of this section, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, the basis of the participating interest or portion thereof withdrawn shall be reduced by such portions of the following items as were allocable to the participant with respect to the participating interest or portion thereof withdrawn:

(1) The amount of the excess of the allowable deductions of the common trust fund over its gross income for the taxable years beginning after December 31, 1935, and before January 1, 1938, and

(2) The amount of the net short-term capital loss, net long-term capital loss, and ordinary net loss of the common trust fund for each taxable year beginning after December 31, 1937.

§ 1.584–5 Returns of banks with respect to common trust funds.

For rules applicable to filing returns of common trust funds, see section 6032 and the regulations thereunder.

§ 1.584–6 Net operating loss deduction.

The net operating loss deduction is not allowed to a common trust fund. Each participant in a common trust fund, however, will be allowed the benefits of such deduction. In the computation of such deduction, a participant in a common trust fund shall take into account its pro rata share of items of income, gain, loss, deduction, or credit of the common trust fund. The character of any such item shall be determined as if the participant had realized such item directly from the source from which realized by the common trust fund, or incurred such item in the same manner as incurred by the common trust fund.

MUTUAL SAVINGS BANKS, ETC.

§ 1.591 Statutory provisions; deduction for dividends paid on deposits.

SEC. 591. *Deduction for dividends paid on deposits.* In the case of mutual savings banks, cooperative banks, and domestic building and loan associations, there shall be allowed as deductions in computing taxable income amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

§ 1.591–1 Deduction for dividends paid on deposits.

(a) *In general.* (1) A mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and

without profit may deduct from gross income amounts which during the taxable year are paid to or credited to the accounts of depositors or holders of accounts, as dividends on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

(2) The deduction provided in section 591 is applicable to the taxable year in which amounts credited as dividends become withdrawable by the depositor or holder of account subject only to customary notice of intention to withdraw. Thus, amounts credited as dividends as of the last day of the taxable year which are not withdrawable by depositors or holders of accounts until the following business day are deductible under section 591 in the year subsequent to the taxable year in which they were credited. A deduction under this section will not be denied by reason of the fact that the amounts credited as dividends, otherwise deductible under section 591, are subject to the terms of a pledge agreement between the institution and the depositor or holder of account. In the case of a building and loan association having nonwithdrawable capital stock represented by shares, no deduction is allowable under this section for amounts paid or credited as dividends on such shares.

(b) *Serial associations, bonus plans, etc.* If a building and loan association operates in whole or in part as a serial association, maintains a bonus plan, or issues shares subject to fines, penalties, forfeitures, or other withdrawal fees, it may deduct under section 591 the total amount credited as dividends upon such shares, credited to a bonus account for shares for the taxable year, notwithstanding that as a customary condition of withdrawal:

(1) Amounts invested in, and earnings credited to, series shares must be withdrawn in multiples of even shares, or

(2) Such association has the right, pursuant to by-law, contract, or otherwise, to retain or recover a portion of the total amount invested in, or credited as earnings upon, such shares, such bonus account, or series of shares, as a fine, penalty, forfeiture, or other withdrawal fee.

In any taxable year in which the right referred to in subparagraph (2) of this paragraph is exercised, there is includible in the gross income of such association for such taxable year amounts retained or recovered by the association pursuant to the exercise of such right.

§ 1.592 Statutory provisions; deduction for repayment of certain loans.

SEC. 592. *Deduction for repayment of certain loans.* In the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, there shall be allowed as deductions in computing taxable income amounts paid by the taxpayer during the taxable year in repayment of loans made before September 1, 1951, by (1) the United States or any agency or instrumentality thereof which is wholly owned by the United States, or (2) any mutual fund established under the authority of the laws of any State.

§ 1.592–1 Repayment of certain loans by mutual savings banks, building and loan associations, and cooperative banks.

There is deductible, under section 592, from the gross income of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, amounts paid by such institutions during the taxable year in repayment of loans made before September 1, 1951, by the United States or any agency or instrumentality thereof which is wholly owned by the United States, or by any mutual fund established under the authority of the laws of any State. For example, amounts paid by such institution in repayment of loans made by the Reconstruction Finance Corporation before September 1, 1951, are deductible under this section. Section 592 is not applicable, however, in the case of amounts paid in repayment of loans made by an agency or instrumentality not wholly owned by the United States.

§ 1.593 Statutory provisions; additions to reserve for bad debts.

SEC. 593. *Additions to reserve for bad debts.* In the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit, the reasonable addition to a reserve for bad debts under section 166 (c) shall be determined with due regard to the amount of the taxpayer's surplus or bad debt reserves existing at the close of December 31, 1951. In the case of a taxpayer described in the preceding sentence, the reasonable addition to a reserve for bad debts for any taxable year shall in no case be less than the amount determined by the taxpayer as the reasonable addition for such year; except that the amount determined by the taxpayer under this sentence shall not be greater than the lesser of—

(1) The amount of its taxable income for the taxable year, computed without regard to this section, or

(2) The amount by which 12 percent of the total deposits or withdrawable accounts of its depositors at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year.

§ 1.593–1 Additions to reserve for bad debts.

(a) *In general.* A mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit may, as an alternative to a deduction from gross income under section 166 (a) for specific debts which become worthless in whole or in part, deduct amounts credited to a reserve for bad debts in the manner and under the circumstances prescribed in this section and § 1.593–2. In the case of such an institution, the selection of either of the alternative methods for treating bad debts may be made by the taxpayer in the return for its first taxable year beginning after December 31, 1951. The method selected shall be subject to the approval of the Commissioner upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, unless permission is granted by the Commissioner to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30 days prior to the close of the taxable year for which the change is to be effective.

(b) *Addition to reserve.* Except as otherwise provided in § 1.593–2, the reasonable addition to a reserve for bad debts shall be any amount determined by the taxpayer which does not exceed the lesser of:

(1) The amount of its taxable income for the taxable year, computed without regard to section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income (such as section 170, relating to charitable, etc., contributions and gifts), or

(2) The amount by which 12 percent of the total deposits or withdrawable accounts of its depositors at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year.

(c) *Adjustments to reserve.* Bad debt losses sustained during the taxable year shall be charged against the bad debt reserve. Recoveries of debts charged against the bad debt reserve during a prior taxable year in which the institution was subject to tax under chapter 1 of the Internal Revenue Code of 1954 or under chapter 1 of the Internal Revenue Code of 1939 shall be credited to the bad debt reserve. The establishment of such reserve and all adjustments made thereto must be reflected on the regular books of account of the institution at the close of the taxable year, or as soon as practicable thereafter. Minimum amounts credited in compliance with Federal or State statutes, regulations, or supervisory orders to reserve or similar accounts, or additional amounts credited to such reserve or similar accounts and permissive under such statutes, regulations, or orders, against which charges may be made for the purpose of absorbing losses sustained by an institution, will be deemed to have been credited to the bad debt reserve.

(d) *Definitions.* When used in this section and in § 1.593–2:

(1) *Institution.* The term "institution" means either a mutual savings bank not having capital stock represented by shares, a domestic building and loan association as defined in section 7701 (a) (19), or a cooperative bank without capital stock organized and operated for mutual purposes and without profit.

(2) *Surplus, undivided profits, and reserves.* (i) The phrase "surplus, undivided profits, and reserves" means the amount by which the total assets of an institution exceed the amount of the total liabilities of such an institution.

(ii) For this purpose the term "total assets" means the sum of money, plus

the aggregate of the adjusted basis of the property other than money, held by an institution. Such adjusted basis for any asset is its adjusted basis for determining gain upon sale or exchange for Federal income tax purposes. (See sections 1011 through 1022, and the regulations thereunder. For special rules with respect to adjustments to basis for prior taxable years during which the institution was exempt from tax, see section 1016 (a) (3) and the regulations thereunder.) The determination of the total assets of any taxpayer shall conform to the method of accounting employed by such taxpayer in determining taxable income and to the rules applicable in determining its earnings and profits.

(iii) The term "total liabilities" means all liabilities of the taxpayer, which are fixed and determined, absolute and not contingent, and includes those items which constitute liabilities in the sense of debts or obligations. The total deposits or withdrawable accounts, as defined in subparagraph (3) of this paragraph, shall be considered a liability. In the case of a building and loan association having permanent nonwithdrawable capital stock represented by shares, the paid-in amount of such stock shall also be considered a liability. Reserves for contingencies and other reserves, however, which are mere appropriations of surplus, are not liabilities.

(3) *Total deposits or withdrawable accounts.* The phrase "total deposits or withdrawable accounts" means the aggregate of (i) amounts placed with an institution for deposit or investment and (ii) earnings outstanding on the books of account of the institution at the close of the taxable year which have been credited as dividends upon such accounts prior to the close of the taxable year, except that such term, in the case of a building and loan association, does not include permanent nonwithdrawable capital stock represented by shares, or earnings credited thereon.

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). (i) Institution X, which keeps its books on the basis of the calendar year, has surplus, reserves, and undivided profits of $800,000 as of January 1, 1955, and total deposits or withdrawable accounts of $10,000,000 as of December 31, 1955. During 1955 the institution credits $30,000, as required by a Federal agency, to a Federal insurance reserve for the sole purpose of absorbing losses. Likewise, it credits $25,000, as permitted by State statute, to another reserve fund for the purpose of absorbing losses. In 1955 Institution X charges $5,000 against its bad debt reserve for losses sustained during the taxable year.

(ii) The taxable income of Institution X for the taxable year 1955, computed without regard to section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is $200,000.

(iii) Upon the basis of the facts as stated in subdivision (i) of this example, the amount by which 12 percent of the total deposits or withdrawable accounts of Institution X at the close of taxable year 1955 exceeds the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year is $400,000 (12 percent of $10,000,000, minus $800,000).

(iv) Institution X, therefore, may deduct, for the taxable year 1955, as an addition to a reserve for bad debts, any amount it may determine that does not exceed the lesser of the amounts determined in subdivision (ii) or (iii) of this example. That amount is $200,000 (as determined in subdivision (ii) of this example). Since under paragraph (c) of this section, the $30,000 credited to the reserve as required by the Federal agency and the $25,000 credited to the reserve as permitted by the State statute are regarded as amounts credited to a reserve for bad debts account, Institution X can credit an additional $145,000 ($200,000 minus $55,000) to a general reserve for bad debts account at any time during the taxable year.

(v) The loss of $5,000 charged to the bad debt reserve during the taxable year does not affect the amount of the addition to the bad debt reserve provided for in paragraph (b) of this section. It is of significance only in determining the surplus, undivided profits, and reserves of Institution X as of January 1, 1956.

Example (2). The taxable income of Institution Y for the taxable year 1955, computed without regard to the deduction under section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is determined to be $250,000. The amount by which 12 percent of the total deposits or withdrawable accounts of Institution Y at the close of the taxable year exceeds the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year is $500,000. Institution Y credits $250,000 to its bad debt reserve in 1955. In 1957, it is determined that the correct taxable income of Institution Y for 1955, computed without regard to any deduction under section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is $275,000 and not $250,000. Assuming that Institution Y credits the additional $25,000 to its bad debt reserve, $275,000 is allowable as a deduction from gross income for such institution for the taxable year 1955.

§ 1.593–2 Additions to reserve for bad debts where surplus, reserves, and undivided profits equal or exceed 12 percent of deposits or withdrawable accounts.

Where 12 percent of the total deposits or withdrawable accounts of an institution at the close of the taxable year is equal to or less than the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year, a reasonable addition to the reserve for bad debts as determined under the general provisions of section 166 (c) may be allowable as a deduction from gross income. In making such determination, there shall be taken into account (a) surplus or bad debt reserves existing at the close of December 31, 1951 (i. e., the amount of surplus, undivided profits, and reserves accumulated prior to January 1, 1952, and in existence at the close of December 31, 1951), and (b) changes in the surplus, undivided profits, and reserves of the institution from December 31, 1951, until the beginning of the taxable year. A deduction for an addition to the reserve for bad debts pursuant to this section will be authorized only in those cases where the institution proves to the satisfaction of the Commissioner that the bad debt experience of the institution warrants an addition to the reserve for bad debts in excess of that provided in paragraph (b) of § 1.593–1. For definitions, see paragraph (d) of § 1.593–1.

§ 1.594 Statutory provisions; alternative tax for mutual savings banks conducting life insurance business.

SEC. 594. *Alternative tax for mutual savings banks conducting life insurance business*—(a) *Alternative tax.* In the case of a mutual savings bank not having capital stock represented by shares, authorized under State law to engage in the business of issuing life insurance contracts, and which conducts a life insurance business in a separate department the accounts of which are maintained separately from the other accounts of the mutual savings bank, there shall be imposed in lieu of the taxes imposed by section 11 or section 1201 (a), a tax consisting of the sum of the partial taxes determined under paragraphs (1) and (2):

(1) A partial tax computed on the taxable income determined without regard to any items of gross income or deductions properly allocable to the business of the life insurance department, at the rates and in the manner as if this section had not been enacted; and

(2) A partial tax computed on the income of the life insurance department determined without regard to any items of gross income or deductions not properly allocable to such department, at the rates and in the manner provided in subchapter L (sec. 801 and following) with respect to life insurance companies.

(b) *Limitations of section.* Subsection (a) shall apply only if the life insurance department would, if it were treated as a separate corporation, qualify as a life insurance company under section 801.

[Sec. 594 as amended by sec. 5(3), Life Insurance Company Tax Act for 1955 (70 Stat. 49)]

§ 1.594–1 Mutual savings banks conducting life insurance business.

(a) *Scope of application.* Section 594 applies to the case of a mutual savings bank not having capital stock represented by shares which conducts a life insurance business, if:

(1) The conduct of the life insurance business is authorized under State law,

(2) The life insurance business is carried on in a separate department of the bank,

(3) The books of account of the life insurance business are maintained separately from other departments of the bank, and

(4) The life insurance department of the bank would, if it were treated as a separate corporation, qualify as a life insurance company under section 801.

(b) *Computation of tax.* In the case of a mutual savings bank conducting a life insurance business to which section 594 is applicable, the tax upon such bank consists of the sum of the following:

(1) A partial tax computed under section 11 upon the taxable income of the bank determined without regard to any items of income or deduction properly allocable to the life insurance department, and

(2) A partial tax computed on the income (or, in the case of taxable years beginning before January 1, 1955, the taxable income (as defined in section 803)) of the life insurance department determined without regard to any items of income or deduction not properly allocable to such department, at the rates and in the manner provided in subchapter L (section 801 and following), chapter 1 of the Code, with respect to life insurance companies.

BANK AFFILIATES

§ 1.601 Statutory provisions; special deduction for bank affiliates.

SEC. 601. *Special deduction for bank affiliates.* In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933; 12 U. S. C. 221a (c)), there shall be allowed as a deduction, for purposes of section 535 (b) (8) (relating to the computation of accumulated taxable income) and section 545 (b) (6) relating to the computation of undistributed personal holding company income), the amount of the earnings and profits which the Board of Governors of the Federal Reserve System certifies to the Secretary or to his delegate has been devoted by such affiliate during the taxable year to the acquisition of readily marketable assets other than bank stock in compliance with section 5144 of the Revised Statutes (12 U. S. C. 61). The amount of the deduction under this section for any taxable year shall not exceed the taxable income for such year computed without regard to the special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.). The aggregate of the deductions allowable under this section and the credits allowable under the corresponding provision of any prior income tax law for all taxable years shall not exceed the amount required to be devoted under such section 5144 to such purposes.

§ 1.601–1 Special deduction for bank affiliates.

(a) The special deduction described in section 601 is allowed:

(1) To a holding company affiliate of a bank, as defined in section 2 of the Banking Act of 1933 (12 U. S. C. 221a), which holding company affiliate holds, at the end of the taxable year, a general voting permit granted by the Board of Governors of the Federal Reserve System.

(2) In the amount of the earnings or profits of such holding company affiliate which, in compliance with section 5144 of the Revised Statutes (12 U.S.C. 61), has been devoted by it during the taxable year to the acquisition of readily marketable assets other than bank stock.

(3) Upon certification by the Board of Governors of the Federal Reserve System to the Commissioner that such an amount of the earnings or profits has been so devoted by such affiliate during the taxable year.

No deduction is allowable under section 601 for the amount of readily marketable assets in excess of what is required by section 5144 of the Revised Statutes (12 U. S. C. 61) to be acquired by such affiliate, or in excess of the taxable income for the taxable year computed without regard to the special deductions for corporations provided in part VIII (section 241 and following), subchapter B, chapter 1 of the Code. Nor may the aggregate of the deductions allowable under section 601 and the credits allowable under the corresponding provision of any prior income tax law for all taxable years exceed the amount required to be devoted under such section 5144 to the acquisition of readily marketable assets other than bank stock.

(b) Every taxpayer claiming a deduction provided for in section 601 shall attach to its return a supplementary statement setting forth all the facts and information upon which the claim is predicated, including such facts and information as the Board of Governors of the Federal Reserve System may prescribe as necessary to enable it, upon the request of the Commissioner subsequent to the filing of the return, to certify to the Commissioner the amount of earnings or profits devoted to the acquisition of such readily marketable assets. A certified copy of such supplementary statement shall be forwarded by the taxpayer to the Board of Governors at the time of the filing of the return. The holding company affiliate shall also furnish the Board of Governors such further information as the Board shall require. For the requirements with respect to the amount of such readily marketable assets which must be acquired and maintained by a holding company affiliate to which a voting permit has been granted, see section 5144 (b) and (c) of the Revised Statutes (12 U. S. C. 61).

NATURAL RESOURCES

DEDUCTIONS

§ 1.611 Statutory provisions; allowance of deduction for depletion.

SEC. 611. *Allowance of deduction for depletion*—(a) *General rule.* In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613 (c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

(b) *Special rules*—(1) *Leases.* In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee.

(2) *Life tenant and remainderman.* In the case of property held by one person for life with remainder to another person, the deduction under this section shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.

(3) *Property held in trust.* In the case of property held in trust, the deduction under this section shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

(4) *Property held by estate.* In the case of an estate, the deduction under this section shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

(c) *Cross reference.* For other rules applicable to depreciation of improvements, see section 167.

[Sec. 611 as amended by sec. 35, Technical Amendments Act 1958 (72 Stat. 1632)]

§ 1.611–1 Allowance of deduction for depletion.

(a) *Depletion of mines, oil and gas wells, other natural deposits, and timber*—(1) *In general.* Section 611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion. In the case of standing timber, the depletion allowance shall be computed solely upon the adjusted basis of the property. In the case of other exhaustible natural resources the allowance for depletion shall be computed upon either the adjusted depletion basis of the property (see section 612, relating to cost depletion) or upon a percentage of gross income from the property (see section 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year. In no case will depletion based upon discovery value be allowed.

(2) See § 1.611–5 for methods of depreciation relating to improvements connected with mineral or timber properties.

(3) See paragraph (d) of this section for definition of terms.

(b) *Economic interest.* (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possess a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

(2) No depletion deduction shall be allowed the owner with respect to any timber or coal that such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber or coal, if such disposal is considered a sale of timber or coal under section 631 (b) or (c).

(c) *Special rules*—(1) *In general.* For the purpose of the equitable apportionment of depletion among the several owners of economic interests in a mineral deposit or standing timber, if the value of any mineral or timber must be ascertained as of any specific date for the determination of the basis for depletion, the values of such several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the mineral or timber as a whole.

(2) *Leases.* In the case of a lease, the deduction for depletion under section 611 shall be equitably apportioned between the lessor and lessee. In the case of a lease or other contract providing for the sharing of economic interests in a mineral deposit or standing timber, such deduction shall be computed by each taxpayer by reference to the adjusted basis of his property determined in accordance with sections 611 and 612, or computed in accordance with section 613, if applicable, and the regulations thereunder.

(3) *Life tenant and remainderman.* In the case of property held by one person for life with remainder to another person, the deduction for depletion under section 611 shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.

(4) *Mineral or timber property held in trust.* If a mineral property or timber property is held in trust, the allowable deduction for depletion is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income from such property allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depletion in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depletion reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

(i) If under the trust instrument or local law the income of a trust computed without regard to depletion is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

(ii) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depletion in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depletion reserve pursuant to discretionary authority to do so in the governing instrument.

No effect shall be given to any allocation of the depletion deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depletion.

(5) *Mineral or timber property held by estate.* In the case of a mineral property or timber property held by an estate, the deduction for depletion under section 611 shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of income of the estate from such property which is allocable to each.

(d) *Definitions.* As used in this part, and the regulations thereunder, the term—

(1) "Property" means—(i) in the case of minerals, each separate economic interest owned in each mineral deposit in each separate tract or parcel of land or an aggregation or combination of such mineral interests permitted under section 614 (b), (c), (d), or (e); and (ii) in the case of timber, an economic interest in standing timber in each tract or block representing a separate timber account (see paragraph (d) of § 1.611–3). For rules with respect to waste or residue of prior mining, see paragraph (c) of § 1.614–1.[1] When, in the regulations under this part, either the word "mineral" or "timber" precedes the word "property", such adjectives are used only to classify the type of "property" involved. For further explanation of the term "property", see section 614 and the regulations thereunder.

(2) "Fair market value" of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase.

(3) "Mineral enterprise" is the mineral deposit or deposits and improvements, if any, used in mining or in the production of oil and gas, and only so much of the surface of the land as is necessary for purposes of mineral extraction. The value of the mineral enterprise is the combined value of its component parts.

(4) "Mineral deposit" refers to minerals in place. When a mineral enterprise is acquired as a unit, the cost of any interest in the mineral deposit or deposits is that proportion of the total cost of the mineral enterprise which the value of the interest in the deposit or deposits bears to the value of the entire enterprise at the time of its acquisition.

(5) "Minerals" includes ores of the metals, coal, oil, gas, and all other natural metallic and nonmetallic deposits, except minerals derived from sea water, the air, or from similar inexhaustible sources. It includes but is not limited to all of the minerals and other natural deposits subject to depletion based upon a percentage of gross income from the property under section 613 and the regulations thereunder.

§ 1.611–2 Rules applicable to mines, oil and gas wells, and other natural deposits.

(a) *Computation of cost depletion of mines, oil and gas wells, and other natural deposits.* (1) The basis upon which cost depletion is to be allowed in respect of any mineral property is the basis provided for in section 612 and the regulations thereunder. After the amount of such basis applicable to the mineral property has been determined for the taxable year, the cost depletion for that year shall be computed by dividing such amount by the number of units of mineral remaining as of the taxable year (see subparagraph (3) of this paragraph), and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year (see subparagraph (2) of this paragraph). In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

(2) As used in this paragraph, the phrase "number of units sold within the taxable year"—

(i) In the case of a taxpayer reporting income on the cash receipts and disbursements method, includes units for which payments were received within the taxable year although produced or sold prior to the taxable year, and excludes units sold but not paid for in the taxable year, and

(ii) In the case of a taxpayer reporting income on the accrual method, shall be determined from the taxpayer's inventories kept in physical quantities and in a manner consistent with his method of inventory accounting under section 471 or 472.

The phrase does not include units with respect to which depletion deductions were allowed or allowable prior to the taxable year.

(3) "The number of units of mineral remaining as of the taxable year" is the number of units of mineral remaining at the end of the year to be recovered from the property (including units recovered but not sold) plus the "number of units sold within the taxable year" as defined in this section.

(4) In the case of a natural gas well where the annual production is not metered and is not capable of being estimated with reasonable accuracy, the taxpayer may compute the cost depletion allowance in respect of such property for the taxable year by multiplying the adjusted basis of the property by a fraction, the numerator of which is equal to the decline in rock pressure during the taxable year and the denominator of which is equal to the expected total decline in rock pressure from the beginning of the taxable year to the economic limit of production. Taxpayers computing depletion by this method must keep accurate records of periodical pressure determinations.

(5) If an aggregation of two or more separate mineral properties is made during a taxable year under section 614, cost depletion for each such property shall be computed separately for that portion of the taxable year ending immediately before the effective date of the aggregation. Cost depletion with respect to the aggregated property shall be computed for that portion of the taxable year beginning on such effective date. The allowance for cost depletion for the taxable year shall be the sum of such cost depletion computations. For purposes of this paragraph, each such portion of the taxable year shall be considered as a taxable year. Similar rules shall be applied where a separate mineral property is properly removed from an existing aggregation during a taxable year.

[1] In process of preparation.

See section 614 and the regulations thereunder for rules relating to the effective date of an aggregation of mineral interests and for rules relating to the adjusted basis of an aggregation.

(6) The apportionment of the deduction among the several owners of economic interests in the mineral deposit or deposits will be made as provided in paragraph (c) of § 1.611–1.

(b) *Depletion accounts of mineral property.* (1) Every taxpayer claiming and making a deduction for depletion of mineral property shall keep a separate account in which shall be accurately recorded the cost or other basis provided by section 1012, of such property together with subsequent allowable capital additions to each account and all the other adjustments required by section 1016.

(2) Mineral property accounts shall thereafter be credited annually with the amounts of the depletion computed in accordance with section 611 or 613 and the regulations thereunder; or the amounts of the depletion so computed shall be credited to depletion reserve accounts. No further deductions for cost depletion shall be allowed when the sum of the credits for depletion equals the cost or other basis of the property, plus allowable capital additions. However, depletion deductions may be allowable thereafter computed upon a percentage of gross income from the property. See section 613 and the regulations thereunder. In no event shall percentage depletion in excess of cost or other basis of the property be credited to the improvements account or the depreciation reserve account.

(c) *Determination of mineral contents of deposits.* (1) If it is necessary to estimate or determine with respect to any mineral deposit as of any specific date the total recoverable units (tons, pounds, ounces, barrels, thousands of cubic feet, or other measure) of mineral products reasonably known, or on good evidence believed, to have existed in place as of that date, the estimate or determination must be made according to the method current in the industry and in the light of the most accurate and reliable information obtainable. In the selection of a unit of estimate, preference shall be given to the principal unit (or units) paid for in the product marketed. The estimate of the recoverable units of the mineral products in the deposit for the purposes of valuation and depletion shall include as to both quantity and grade:

(i) The ores and minerals "in sight", "blocked out", "developed", or "assured", in the usual or conventional meaning of these terms with respect to the type of the deposits, and

(ii) "Probable" or "prospective" ores or minerals (in the corresponding sense), that is, ores or minerals that are believed to exist on the basis of good evidence although not actually known to occur on the basis of existing development. Such "probable" or "prospective" ores or minerals may be estimated:

(*a*) As to quantity, only in case they are extensions of known deposits or are new bodies or masses whose existence is indicated by geological surveys or other evidence to a high degree of probability, and

(*b*) As to grade, only in accordance with the best indications available as to richness.

(2) If the number of recoverable units of mineral in the deposit has been previously estimated for the prior year or years, and if there has been no known change in the facts upon which the prior estimate was based, the number of recoverable units of mineral in the deposit as of the taxable year will be the number remaining from the prior estimate. However, for any taxable year for which it is ascertained either by the taxpayer or the district director from any source, such as operations or development work prior to the close of the taxable year, that the remaining recoverable mineral units as of the taxable year are materially greater or less than the number remaining from the prior estimate, then the estimate of the remaining recoverable units shall be revised, and the annual cost depletion allowance with respect to the property for the taxable year and for subsequent taxable years will be based upon the revised estimate until a change in the facts requires another revision. Such revised estimate will not, however, change the adjusted basis for depletion.

(d) *Determination of fair market value of mineral properties, and improvements, if any.* (1) If the fair market value of the mineral property and improvements at a specified date is to be determined for the purpose of ascertaining the basis, such value must be determined, subject to approval or revision by the district director, by the owner of such property and improvements in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments or subsequent improvements in methods of extraction and treatment of the mineral product. The district director will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties and improvements, bona fide offers, market value of stock or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property and improvements was in question, the amount at which the property and improvements may have been inventoried or appraised in probate or similar proceedings, and disinterested appraisals by approved methods.

(2) If the fair market value must be ascertained as of a certain date, analytical appraisal methods of valuation, such as the present value method will not be used:

(i) If the value of a mineral property and improvements, if any, can be determined upon the basis of cost or comparative values and replacement value of equipment, or

(ii) If the fair market value can reasonably be determined by any other method.

(e) *Determination of the fair market value of mineral property by the present value method.* (1) To determine the fair market value of a mineral property and improvements by the present value method, the essential factors must be determined for each mineral deposit. The essential factors in determining the fair market value of mineral deposits are:

(i) The total quantity of mineral in terms of the principal or customary unit (or units) paid for in the product marketed,

(ii) The quantity of mineral expected to be recovered during each operating period,

(iii) The average quality or grade of the mineral reserves,

(iv) The allocation of the total expected profit to the several processes or operations necessary for the preparation of the mineral for market,

(v) The probable operating life of the deposit in years,

(vi) The development cost,

(vii) The operating cost,

(viii) The total expected profit,

(ix) The rate at which this profit will be obtained, and

(x) The rate of interest commensurate with the risk for the particular deposit.

(2) If the mineral deposit has been sufficiently developed, the valuation factors specified in subparagraph (1) of this paragraph may be determined from past operating experience. In the application of factors derived from past experience, full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, cost of development, production, interest rate, and selling price of the product marketed during the expected operating life of the mineral deposit. Mineral deposits for which these factors cannot be determined with reasonable accuracy from past operating experience may also be valued by the present value method; but the factors must be deduced from concurrent evidence, such as the general type of the deposit, the characteristics of the district in which it occurs, the habit of the mineral deposits, the intensity of mineralization, the oil-gas ratio, the rate at which additional mineral has been disclosed by exploitation, the stage of the operating life of the deposit, and any other evidence tending to establish a reasonable estimate of the required factors.

(3) Mineral deposits of different grades, locations, and probable dates of extraction should be valued separately. The mineral content of a deposit shall be determined in accordance with paragraph (c) of this section. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases or decreases as indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or reasonably to be expected for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at the rate de-

termined as above. The operating life of oil and gas wells is also influenced by the natural decline in pressure and flow, and by voluntary or enforced curtailment of production. The operating cost includes all current expense of producing, preparing, and marketing the mineral product sold (due consideration being given to taxes) exclusive of allowable capital additions, as described in §§ 1.612–2 and 1.612–4, and deductions for depreciation and depletion, but including cost of repairs. This cost of repairs is not to be confused with the depreciation deduction by which the cost of improvements is returned to the taxpayer free from tax. In general, no estimates of these factors will be approved by the district director which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods.

(4) The value of each mineral deposit is measured by the expected gross income (the number of units of mineral recoverable in marketable form multiplied by the estimated market price per unit) less the estimated operating cost, reduced to a present value as of the date for which the valuation is made at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at that date of the improvements and of the capital additions, if any, necessary to realize the profits. The degree of risk is generally lowest in cases where the factors of valuation are fully supported by the operating record of the mineral enterprise before the date for which the valuation is made. On the other hand, higher risks ordinarily attach to appraisals upon any other basis.

(f) *Revaluation of mineral property not allowed.* No revaluation of a mineral property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner.

(g) *Statement to be attached to return when valuation, depletion, or depreciation of mineral property or improvements are claimed.* (1) For the first taxable year for which a taxpayer asserts a value for any mineral property or improvement as of a specific date or claims a deduction for depletion, or depreciation, there shall be attached to the return of the taxpayer for such taxable year a statement setting forth, in complete, summary form, the pertinent information required by this paragraph with respect to each such mineral property or improvement (including oil and gas properties or improvements). The summary statement shall be deemed a part of the income tax return to which it relates. In addition to such summary statement, the taxpayer must assemble, segregate and have readily available at his principal place of business, all the supporting data (listed in subparagraphs (2), (3), and (4) of this paragraph) which is used in compiling the summary statement. After such first taxable year the taxpayer need attach to his return only an explanation of the changes, if any, in the information previously furnished. For example, when a taxpayer has filed adequate maps with the district director he may be relieved of filing further maps of the same area, if all additional information necessary for keeping the maps up-to-date is filed each year. In any case in which any of the information required by this paragraph has been previously filed by the taxpayer (including information furnished in accordance with corresponding provisions of prior regulations), such information need not be filed again but a statement should be attached to the return of the taxpayer indicating clearly when and in what form such information was previously filed.

(2) The information referred to in subparagraph (1) of this paragraph is as follows:

(i) An adequate map showing the name, description, location, date of surveys, and identification of the deposit or deposits;

(ii) A description of the character of the taxpayer's property, accompanied by a copy of the instrument or instruments by which it was acquired;

(iii) The date of acquisition of the property, the exact terms and dates of expiration of all leases involved, and if terminated, the reasons therefor;

(iv) The cost of the mineral property and improvements, stating the amount paid to each vendor, with his name and address;

(v) The date as of which the mineral property and improvements are valued, if a valuation is necessary to establish the basis as provided by section 1012;

(vi) The value of the mineral property and improvements on that date with a statement of the precise method by which it was determined;

(vii) An allocation of the cost or value among the mineral property, improvements and the surface of the land for purposes other than mineral production;

(viii) The estimated number of units of each kind of mineral at the end of the taxable year, and also at the date of acquisition, if acquired during the taxable year or at the date as of which any valuation is made, together with an explanation of the method used in the estimation, the name and address of the person making the estimate, and an average analysis which will indicate the quality of the mineral valued, including the grade or gravity in the case of oil;

(ix) The number of units sold and the number of units for which payment was received or accrued during the year for which the return is made (in the case of newly developed oil and gas deposits it is desirable that this information be furnished by months);

(x) The gross amount received from the sale of mineral;

(xi) The amount of depreciation for the taxable year and the amount of cost depletion for the taxable year;

(xii) The amounts of depletion and depreciation, if any, stated separately, which for each and every prior year:

(*a*) Were allowed (see section 1016 (a) (2)),

(*b*) Were allowable, and

(*c*) Would have been allowable without reference to percentage or discovery depletion;

(xiii) The fractions (however measured) of gross production from the deposit or deposits to which the taxpayer and other persons are entitled together with the names and addresses of such other persons; and

(xiv) Any other data which will be helpful in determining the reasonableness of the valuation asserted or of the deductions claimed.

(3) In the case of oil and gas properties, the following information with respect to each property is required in addition to that information set forth in subparagraph (2) of this paragraph:

(i) The number of acres of producing oil or gas land and, if additional acreage is claimed to be proven, the amount of such acreage and the reasons for believing it to be proven;

(ii) The number of wells producing at the beginning and end of the taxable year;

(iii) The date of completion of each well finished during the taxable year;

(iv) The date of abandonment of each well abandoned during the taxable year;

(v) Maps showing the location of the tracts or leases and of the producing and abandoned wells, dry holes, and proven oil and gas lands (the maps should show depth, initial production, and date of completion of each well, etc., to the extent that these data are available);

(vi) The number of pay sands and average thickness of each pay sand or zone;

(vii) The average depth to the top of each of the different pay sands;

(viii) The annual production of the deposit or of the individual wells, if the latter information is available, from the beginning of its productivity to the end of the taxable year, the average number of wells producing during each year, and the initial daily production of each well (the extent to which oil or gas is used for fuel on the premises should be stated with reasonable accuracy);

(ix) All available data regarding change in operating conditions, such as unit operation, proration, flooding, use of air-gas lift, vacuum, shooting, and similar information, which have a direct effect on the production of the deposit; and

(x) Available geological information having a probable bearing on the oil and gas content; information with respect to edge water, water drive, bottom hole pressures, oil-gas ratio, porosity of reservoir rock, percentage of recovery, expected date of cessation of natural flow, decline in estimated potential, and characteristics similar to characteristics of other known fields.

(4) For rules relating to an additional statement to be attached to the return when the depletion deduction is computed upon a percentage of gross income from the property, see § 1.613–5.

§ 1.611–3 Rules applicable to timber.

(a) *Capital recoverable through depletion allowance in case of timber.* In general, the capital remaining in any year recoverable through depletion allowances is the basis provided by section 612 and the regulations thereunder. For the method of determining fair market value and quantity of timber, see paragraphs (d), (e), and (f) of this section. For capitalization of carrying charges, see section 1016(a)(1)(A). Amounts paid or incurred in connection with the planting of timber (including planting for Christmas tree purposes) shall be capitalized and recoverable through depletion allowances. Such amounts include, for example, expenditures made for the preparation of the timber site for planting or for natural seeding and the cost of seedlings. The apportionment of deductions between the several owners of economic interests in standing timber will be made as provided in paragraph (c) of § 1.611–1.

(b) *Computation of allowance for depletion of timber for taxable year.* (1) The depletion of timber takes place at the time timber is cut, but the amount of depletion allowable with respect to timber that has been cut may be computed when the quantity of cut timber is first accurately measured in the process of exploitation. To the extent that depletion is allowable in a particular taxable year with respect to timber the products of which are not sold during such year, the depletion so allowable shall be included as an item of cost in the closing inventory of such products for such year.

(2) The depletion unit of the timber for a given timber account in a given year shall be the quotient obtained by dividing (i) the basis provided by section 1012 and adjusted as provided by section 1016, of the timber on hand at the beginning of the year plus the cost of the number of units of timber acquired during the year plus proper additions to capital, by (ii) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account. The number of units of timber of a given timber account cut during any taxable year multiplied by the depletion unit of that timber account applicable to such year shall be the amount of depletion allowable for the taxable year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on such basis, in which case the amount allowable on account of depletion for a given month will be determined in the manner outlined herein for a given year. The total amount of the allowance for depletion in any taxable year shall be the sum of the amounts allowable for the several timber accounts. For a description of timber accounts, see paragraphs (c) and (d) of this section.

(3) When a taxpayer has elected to treat the cutting of timber as a sale or exchange of such timber under the provisions of section 631(a), he shall reduce the timber account containing such timber by an amount equal to the adjusted depletion basis of such timber. In computing any further gain or loss on such timber, see paragraph (e) of § 1.631–1.

(c) *Timber depletion accounts on books.* (1) Every taxpayer claiming or expecting to claim a deduction for depletion of timber property shall keep accurate ledger accounts in which shall be recorded the cost or other basis provided by section 1012 of the property and land together with subsequent allowable capital additions in each account and all other adjustments provided by section 1016 and the regulations thereunder.

(2) In such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total cost or value shall be allocated to each after proper provision for immature timber growth. See paragraph (d) of this section. The timber accounts shall be credited each year with the amount of the charges to the depletion accounts computed in accordance with paragraph (b) of this section or the amount of the charges to the depletion accounts shall be credited to depletion reserve accounts. When the sum of the credits for depletion equals the cost or other basis of the timber property, plus subsequent allowable capital additions, no further deduction for depletion will be allowed.

(d) *Aggregating timber and land for purposes of valuation and accounting.* (1) With a view to logical and reasonable valuation of timber, the taxpayer shall include his timber in one or more accounts. In general, each such account shall include all of the taxpayer's timber which is located in one "block". A block may be an operation unit which includes all the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance, or in which the logs or other products will probably be sold in a log or other market, the block may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development. Blocks may also be established by geographical or political boundaries or by logical management areas. Timber acquired under cutting contracts should be carried in separate accounts and shall not constitute part of any block. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the district director on audit, the taxpayer may divide the timber in a given block into two or more accounts. For example, timber owned on February 28, 1913, and that purchased subsequently may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts. Individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts. Blocks may be divided into two or more accounts based on the character of the timber or its accessibility, or scattered tracts may be included in separate accounts. If such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(2) The timber accounts mentioned in subparagraph (1) of this paragraph shall not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in subparagraph (1) of this paragraph, the land in a given "block" may be carried in a single land account or may be divided into two or more accounts on the basis of its character or accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(3) The total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts, respectively. In cases in which immature timber growth is a factor, a reasonable portion of the total value or cost shall be allocated to such immature timber, and when the timber becomes merchantable such value or cost shall be recoverable through depletion allowances.

(4) Each of the several land and timber accounts carried on the books of the taxpayer shall be definitely described as to their location on the ground either by maps or by legal descriptions.

(5) For good and substantial reasons satisfactory to the district director, or as required by the district director on audit, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts.

(e) *Determination of quantity of timber.* Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, log scale, cords, or other units) of timber reasonably known, or on good evidence believed, to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, whichever date is applicable in determining the basis for cost depletion. This estimate shall state as nearly as possible the number of units which would have been found present by careful estimate made on the specified date with the object of determining 100 percent of the quantity of timber which the area covered by the specific account would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return, as the result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work, it is ascertained either by the taxpayer or the district director that there remain on the ground, available for utilization, more or less units of timber at the close of the taxable year (or at the close of the month if the tax-

payer keeps his depletion accounts on a monthly basis) than remain in the timber account or accounts on the basis of the original estimate, then the original estimate (but not the basis for depletion) shall be revised. The depletion unit shall be changed when such revision has been made. The annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which the revision is made and all subsequent taxable years until a change in facts requires another revision.

(f) *Determination of fair market value of timber property.* (1) If the fair market value of the property at a specified date is the basis for depletion deductions, such value shall be determined, subject to approval or revision by the district director upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, and methods of exploitation, in degree of utilization, etc. Such factors as the following will be given due consideration:

(i) Character and quality of the timber as determined by species, age, size, condition, etc.;

(ii) The quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber;

(iii) Accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation and the climate and the state of industrial development of the locality); and

(iv) The freight rates by common carrier to important markets.

(2) The timber in each particular case will be valued on its own merits and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned in this paragraph, will be consistent with that of other similar timber in the region. The district director will give weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried or appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors.

(g) *Revaluation of timber property not allowed.* No revaluation of a timber property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The depletion unit shall be revised when such a revaluation of a timber property has been made and the annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which such revision is made and for all subsequent taxable years.

(h) *Information to be furnished by taxpayer claiming depletion of timber.* A taxpayer claiming a deduction for depletion of timber and for depreciation of plant and other improvements shall attach to his income tax return a filled-out Form T-Timber for the taxable year covered by the income tax return, including the following information:

(1) A map where necessary to show clearly timber and land acquired, timber cut, and timber and land sold;

(2) Description of, cost of, and terms of purchase of timberland or timber, or cutting rights, including timber or timber rights acquired under any type of contract;

(3) Profit or loss from sale of land, or timber, or both;

(4) Description of timber with respect to which claim for loss, if any, is made;

(5) Record of timber cut;

(6) Changes in each timber account as a result of purchase, sale, cutting, re-estimate, or loss;

(7) Changes in improvements accounts as the result of additions to or deductions from capital and depreciation, and computation of profit or loss on sale or other disposition of such improvements;

(8) Operation data with respect to raw and finished material handled and inventoried;

(9) Statement as to application of the election under section 631 (a) and pertinent information in support of the fair market value claimed thereunder;

(10) Information with respect to land ownership and capital investment in timberland; and

(11) Any other data which will be helpful in determining the reasonableness of the depletion or depreciation deductions claimed in the return.

§ 1.611–4 Depletion as a factor in computing earnings and profits for dividend purposes.

For rules with respect to computation of earnings and profits where depletion is a factor in the case of corporations, see paragraph (c)(1) of § 1.312–6.

§ 1.611–5 Depreciation of improvements.

(a) *In general.* Section 611 provides in the case of mines, oil and gas wells, other natural deposits, and timber that there shall be allowed as a deduction a reasonable allowance for depreciation of improvements. Such allowance shall include exhaustion, wear and tear, and obsolescence. The deduction allowed under section 611 shall be determined under the provisions of section 167 and the regulations thereunder. For purposes of section 167 the unit of production method may, under appropriate circumstances, be considered a reasonable method under section 167(a), and therefore, not subject to the limitations prescribed by section 167(b).

(b) *Special rules for mines, oil and gas wells, other natural deposits and timber.* (1) For principles governing the apportioning of depreciation allowances under sections 611 and 167 in the case of property held by one person for life with remainder to another or in the case of property held in trust or by an estate, see § 1.167(g)–1.

(2) A reasonable allowance for depreciation on account of obsolescence or decay shall be required in an appropriate case during periods when the improvement is not used in production or is used in producing at a rate below its normal capacity. This rule is applicable whether or not the taxpayer uses the unit of production method.

(3) See sections 615 and 616 and the regulations thereunder for special rules for treatment of allowances for depreciation of improvements with respect to the exploration and development of a mine or other natural deposit (other than oil or gas).

(4) In the case of operating oil or gas properties, the deduction for depreciation shall be allowed for those costs of improvements such as machinery, tools, equipment, pipes and other similar items and the costs of installation which are not treated as a deductible expense under section 263(c). See § 1.612–4.[1]

(c) *Accounting and record keeping.* See § 1.167(a)–7 for accounting and record keeping requirements for taxpayers claiming deductions under section 611 and this section.

§ 1.612 Statutory provisions; basis for cost depletion.

SEC. 612. *Basis for cost depletion.* Except as otherwise provided in this subchapter, the basis on which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain upon the sale or other disposition of such property.

§ 1.612–1 Basis for allowance of cost depletion.

(a) *In general.* The basis upon which the deduction for cost depletion under section 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in section 1011 for the purpose of determining gain upon the sale or other disposition of such property except as provided in paragraph (b) of this section. The adjusted basis of such property is the cost or other basis determined under section 1012, relating to the basis of property, adjusted as provided in section 1016, relating to adjustments to basis, and the regulations under such sections. In the case of the sale of a part of such property, the unrecovered basis thereof shall be allocated to the part sold and the part retained.

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[1] In process of preparation.

(b) *Special rules.* (1) The basis for cost depletion of mineral or timber property does not include:

(i) Amounts recoverable through depreciation deductions, through deferred expenses, and through deductions other than depletion, and

(ii) The residual value of land and improvements at the end of operations.

In the case of any mineral property the basis for cost depletion does not include amounts representing the cost or value of land for purposes other than mineral production. Furthermore, in the case of certain mineral properties, such basis does not include exploration or development expenditures which are treated under section 615(b) or 616(b) as deferred expenses to be taken into account as deductions on a ratable basis as the units of minerals benefited thereby are produced and sold. However, there shall be included in the basis for cost depletion of oil and gas property the amounts of capitalized drilling and development costs which, as provided in § 1.612–4,[1] are recoverable through depletion deductions. In the case of timber property, the basis for cost depletion does not include amounts representing the cost or value of land.

(2) Where a taxpayer elects to treat the cutting of timber as a sale or exchange of such timber, the basis for cost depletion shall be the fair market value of such timber as of the first day of the taxable year in which such timber is cut and such value shall be considered for such taxable year and all subsequent taxable years as the cost of such timber for all purposes for which such cost is a necessary factor. See section 631(a).

(c) *Cross references.* In cases where the valuation, revaluation, or mineral content of deposits is a factor, see paragraphs (c), (d), (e), and (f) of § 1.611–2. In cases where the valuation, revaluation, or quantity of timber is a factor, see paragraphs (e), (f), and (g) of § 1.611–3. For definitions of the terms "property", "fair market value", "mineral enterprise", "mineral deposit", and "minerals", see paragraph (d) of § 1.611–1. For rules with respect to treatment of depletion accounts on taxpayers' books, see paragraph (b) of § 1.611–2 in the case of mineral property, and paragraph (c) of § 1.611–3 in the case of timber property.

[1] In process of preparation.

§ 1.612–2 Allowable capital additions in case of mines.

(a) *In general.* Expenditures for improvements and for replacements, not including expenditures for ordinary and necessary maintenance and repairs, shall ordinarily be charged to capital account recoverable through depreciation deductions. Expenditures for equipment (including its installation and housing) and for replacements thereof, which are necessary to maintain the normal output solely because of the recession of the working faces of the mine and which—

(1) Do not increase the value of the mine, or

(2) Do not decrease the cost of production of mineral units, or

(3) Do not represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made

shall be deducted as ordinary and necessary business expenses.

(b) *Special rule.* For special provisions applicable to treatment of expenditures for certain exploration and development costs (other than for the acquisition, restoration, or betterment of improvements) with respect to minerals other than oil or gas, see sections 615 and 616 and the regulations thereunder.

§ 1.612–3 Depletion; treatment of bonus and advanced royalty.

(a) *Bonus.* (1) If a bonus in addition to royalties is received upon the grant of an economic interest in a mineral deposit, or standing timber, there shall be allowed to the payee as a cost depletion deduction in respect of the bonus an amount equal to that proportion of his basis for depletion as provided in section 612 and § 1.612–1 which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the payee's basis for depletion and the remainder of the basis is recoverable through depletion deductions as the royalties are thereafter received. (But see paragraph (e) of this section.) For example, a taxpayer leases mineral property to another reserving a one-eighth royalty and in addition receives a bonus of $10,000. Assuming that the taxpayer's basis with respect to the mineral property is $21,000 and that the royalties expected to be received are estimated to total $20,000, the depletion on the bonus would be $7,000

$$\left(\frac{\$21{,}000\ \text{(basis)} \times \$10{,}000\ \text{(bonus)}}{\$30{,}000\ \text{(bonus plus estimated royalties)}}\right).$$

The remaining $14,000 of basis will be recovered through depletion as the royalties are received.

(2) If the grant of an economic interest in a mineral deposit or standing timber with respect to which a bonus was received expires, terminates, or is abandoned before there has been any income derived from the extraction of mineral or cutting of timber, the payee shall adjust his capital account by restoring thereto the depletion deduction taken on the bonus and a corresponding amount must be returned as income in the year of such expiration, termination, or abandonment.

(3) In the case of the payor, payment of the bonus constitutes a capital investment made for the acquisition of an economic interest in a mineral deposit or standing timber recoverable through the depletion allowance. See paragraph (c)(5)(ii) of § 1.613–2 in cases in which percentage depletion is used.

(b) *Advanced royalties.* (1) If the owner of an operating interest in a mineral deposit or standing timber is required to pay royalties on a specified number of units of such mineral or timber annually whether or not extracted or cut within the year, and may apply any amounts paid on account of units not extracted or cut within the year against the royalty on the mineral or timber thereafter extracted or cut, the payee shall compute cost depletion on the number of units so paid for in advance of extraction or cutting and shall treat the amount so determined as an allowable deduction for depletion from the gross income of the year in which such payment or payments are made. No deduction for depletion by such payee shall be claimed or allowed in any subsequent year on account of the extraction or cutting in such year of any mineral or timber so paid for in advance and for which deduction has once been made. (But see paragraph (e) of this section.)

(2) If the right to extract minerals or to cut timber against which the advanced royalties may be applied expires, terminates, or is abandoned before all such minerals or timber have been extracted or cut, the payee shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of any units of mineral or timber paid for in advance but not extracted or cut, and a corresponding amount must be returned as income for the year of such expiration, termination or abandonment. (But see paragraph (e) of this section.)

(3) The payor, at his option, may treat the advanced royalties so paid or accrued in connection with mineral property as follows:

(i) As deductions from gross income for the year the advanced royalties are paid or accrued, or

(ii) As deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid, is sold.

For an exception to this treatment when the payor is a sublessor of coal, see paragraph (b)(3) of § 1.631–3. Every taxpayer must make an election as to the treatment of all such advanced royalties in his return for the first taxable year in which such amounts are paid or accrued. A taxpayer will be considered to have made an election in accordance with the manner in which such items are treated in the return. A failure to deduct any such items for the year paid or accrued will constitute an election to have all such items treated in accordance with subdivision (ii) of this subparagraph. Any election made under this section is binding for the taxable year for which made and for all subsequent years, and the taxpayer must treat all advanced royalties paid or accrued in all subsequent years in the same manner. This paragraph does not grant a new election. Any taxpayer who made an election under 26 CFR (1939) 39.23(m)–10(e) (Regulations 118) or corresponding provisions of prior regulations is, by such election, bound with respect to treatment of such advanced royalties whether paid or accrued before or after December 31, 1953. See section 7807(b)(2). For additional rules relating to elections in the case of partners and partnerships, see section 703(b) and the regulations thereunder.

(4) The application of subparagraphs (2) and (3) of this paragraph may be illustrated by the following examples:

Example (1). B leased certain mineral lands from A under a lease in which A reserved a royalty of 10 cents a ton on minerals mined and sold by B. The lease also provided that B had to pay an annual minimum royalty of $10,000 representing the amount due on 100,000 tons of the particular mineral whether or not B mined and sold that amount. It was further provided that, if B did not mine and sell 100,000 tons in any year, he could mine and sell in any subsequent year the amount of mineral on which he had paid the royalty without the payment of any additional royalty. However, this right of recoupment was limited to minerals mined and sold in any later year in excess of the 100,000 tons represented by the $10,000 minimum royalty required to be paid for that later year. Assume that in 1956 B paid A the minimum royalty of $10,000, but mined and sold only 60,000 tons of the mineral and that in 1957 he abandoned the lease without any further production. Since the $10,000 represents royalties on 100,000 tons of mineral and only 60,000 tons were mined and sold, A must restore in 1957 to his capital account the depletion deductions taken in 1956 on $4,000 on account of the 40,000 tons paid for in advance but not mined and sold, and must also return the corresponding amount as income in 1957.

Example (2). Assume that B, under the lease in example (1), paid the $10,000 minimum royalty and mined no minerals in 1956 but that in 1957 B mined and sold 200,000 tons of mineral. If this is B's first such expenditure, B has an option, for the purpose of computing taxable income under section 63, to deduct in 1956 the $10,000 paid in that year although no mineral was mined, or to take the deduction in 1957 when the mineral, for which the $10,000 was paid in 1956, was mined and sold. (For treatment under percentage depletion, see example in paragraph (c) (5) (iii) of § 1.613–2.)

(c) *Delay rental.* (1) A delay rental is an amount paid for the privilege of deferring development of the property and which could have been avoided by abandonment of the lease, or by commencement of development operations, or by obtaining production.

(2) Since a delay rental is in the nature of rent it is ordinary income to the payee and not subject to depletion. The payor may at his election deduct such amount as an expense, or under section 266 and the regulations thereunder, charge it to depletable capital account.

(d) *Percentage depletion deduction with respect to bonus and advanced royalty.* In lieu of the allowance based on cost depletion computed under paragraphs (a) and (b) of this section, the payees referred to therein may be allowed a depletion deduction in respect of any bonus or advanced royalty for the taxable year in an amount computed on the basis of the percentage of gross income from the property as provided in section 613 and the regulations thereunder.

(e) *Cross reference.* In the case of bonuses and advanced royalties received in connection with a contract of disposal of timber or coal covered by section 631 (b) and (c), respectively, see that section and the regulations thereunder.

§ 1.612–4 [Reserved]

§ 1.613 Statutory provisions; percentage depletion.

SEC. 613. *Percentage depletion*—(a) *General rule.* In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage depletion rates.* The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

(2) 23 percent—

(A) Sulfur and uranium; and

(B) If from deposits in the United States—anorthosite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, beryl, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite talc, and zircon, and ores of the following metals: antimony, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanium, tungsten, vanadium, and zinc.

(3) 15 percent—ball clay, bentonite, china clay, sagger clay, metal mines (if paragraph (2) (B) does not apply), rock asphalt, and vermiculite.

(4) 10 percent—asbestos (if paragraph (2) (B) does not apply), brucite, coal, lignite, perlite, sodium chloride, and wollastonite.

(5) 5 percent—

(A) Brick and tile clay, gravel, mollusk shells (including clam shells and oyster shells), peat, pumice, sand, scoria, shale, and stone, except stone described in paragraph (6); and

(B) If from brine wells—bromine, calcium chloride, and magnesium chloride.

(6) 15 percent—all other minerals (including, but not limited to, aplite, barite, borax, calcium carbonates, refractory and fire clay, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (2) (B) does not apply) bauxite, beryl, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc, including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include—

(A) Soil, sod, dirt, turf, water, or mosses; or

(B) Minerals from sea water, the air, or similar inexhaustible sources.

(c) *Definition of gross income from property.* For purposes of this section—

(1) *Gross income from the property.* The term "gross income from the property" means, in the case of property other than an oil or gas well, the gross income from mining.

(2) *Mining.* The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

(3) *Extraction of the ores or minerals from the ground.* The term "extraction of the ores or minerals from the ground" includes the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. The preceding sentence shall not apply to any such extraction of the mineral or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom.

(4) *Ordinary treatment processes.* The term "ordinary treatment processes" includes the following:

(A) In the case of coal—cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment;

(B) In the case of sulfur recovered by the Frasch process—pumping to vats, cooling, breaking, and loading for shipment;

(C) In the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment;

(D) In the case of lead, zinc, copper, gold, silver, or fluorspar ores, potash and ores which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including as an ordinary treatment process electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore, including the furnacing of quicksilver ores; and

(E) The pulverization of talc, the burning of magnesite, and the sintering and nodulizing of phosphate rock.

(d) *Application of percentage depletion rates to certain taxable years ending in 1954*—(1) *General rule.* At the election of the taxpayer in respect of any property (within the meaning of the Internal Revenue Code of 1939), the percentage specified in subsection (b) in the case of any mine, well, or other natural deposit listed in such subsection shall apply to a taxable year ending after December 31, 1953, to which the Internal Revenue Code of 1939 applies.

(2) *Method of computation.* The allowance for depletion, in respect of any property for which an election is made under paragraph (1) for any taxable year, shall be an amount equal to the sum of—

(A) That portion of a tentative allowance, computed under the Internal Revenue Code of 1939 without regard to paragraph (1) of this subsection, which the number of days in such taxable year before January 1, 1954, bears to the total number of days in such taxable year; plus

(B) That portion of a tentative allowance, computed under the Internal Revenue Code of 1939 (as modified solely by the application of paragraph (1) of this subsection), which the number of days in such taxable year after December 31, 1953, bears to the total number of days in such taxable year.

[Sec. 613 as amended by sec. 36, Technical Amendments Act 1958 (72 Stat. 1633)]

§ 1.613–1 Percentage depletion; general rule.

In the case of a taxpayer computing the deduction for depletion under section 611 with respect to minerals on the basis of a percentage of gross income from the property, as defined in section 613(c) and § 1.613–3, such deduction shall be the percentage of such gross income as specified in section 613(b) and § 1.613–2. The deduction shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). Such taxable income shall be computed in accordance with § 1.613–4. In no case shall the deduction for depletion computed under this section be less than the deduction computed upon the cost or other basis of the property provided in section 612 and the regulations thereunder. The apportionment of the deduction between the several owners of economic interests in a mineral deposit will be made as provided in paragraph (c) of § 1.611–1. For rules with respect to "gross income from the property" and for definition of the term "mining", see § 1.613–3. For definitions of the terms "property", "mineral deposit", and "minerals", see paragraph (d) of § 1.611–1.

§ 1.613–2 Percentage depletion rates.

(a) *In general.* Subject to the provisions of paragraph (b) of this section and as provided in section 613(b), in the case of mines, wells, or other natural deposits, a taxpayer may deduct as an allowance for depletion under section 611 the percentages of gross income from the property as set forth in subparagraphs (1), (2), and (3) of this paragraph.

(1) *Without regard to situs of deposits.* The following rates are applicable to the minerals listed in this subparagraph regardless of the situs of the deposits from which the minerals are produced:

(i) 27½ percent—Gas wells, oil wells.

(ii) 23 percent—Sulfur, uranium.

(iii) 15 percent—Ball clay, bentonite, china clay, metal mines,[1] sagger clay, rock asphalt, vermiculite.

(iv) 10 percent—Asbestos,[1] brucite, coal, lignite, perlite, sodium chloride, wollastonite.

(v) 5 percent—Brick and tile clay, gravel, mollusk shells (including clam shells and oyster shells), peat, pumice, sand, scoria, shale, stone (except dimension or ornamental stone). If from brine wells—Bromine, calcium chloride, magnesium chloride.

(2) *Production from United States deposits.* A rate of 23 percent is applicable to the minerals listed in this subparagraph if produced from deposits within the United States:

Anorthosite.[2]	Ilmenite.
Asbestos.	Kyanite.
Bauxite.	Mica.
Beryl.	Olivine.
Celestite.	Quartz crystals (radio grade).
Chromite.	Rutile.
Corundum.	Block steatite talc.
Fluorspar.	Zircon.
Graphite.	

Ores of the following metals—

Antimony.	Platinum.
Bismuth.	Platinum group metals.
Cadmium.	Tantalum.
Cobalt.	Thorium.
Columbium.	Tin.
Lead.	Titanium.
Lithium.	Tungsten.
Manganese.	Vanadium.
Mercury.	Zinc.
Nickel.	

(3) *Other minerals.* A rate of 15 percent is applicable to the minerals listed in this subparagraph regardless of the situs of the deposits from which the minerals are produced, provided the minerals are not used or sold for use by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. If, however, such minerals are sold or used for the purposes described in the preceding sentence, a rate of 5 percent is applicable to any of such minerals unless sold on bid in direct competition with a bona fide bid to sell any of the minerals listed in subdivision (iii) of subparagraph (1) of this paragraph, in which case the rate is 15 percent. In addition, the provisions of this subparagraph are not applicable with respect to any of the minerals listed herein if the rate prescribed in subparagraph (2) of this paragraph is applicable:

Aplite.	Magnesite.
Barite.	Magnesium carbonates.
Bauxite.[3]	Marble.
Beryl.[3]	Mica.[3]
Borax.	Phosphate rock.
Calcium carbonates.	Potash.
Clay, refractory and fire.	Quartzite.
Diatomaceous earth.	Slate.
Dolomite.	Soapstone.
Feldspar.	Spodumene.[3]
Flake graphite.[3]	Stone (dimension or ornamental).[4]
Fluorspar.[3]	Talc[3] (including pyrophyllite).
Fullers earth.	Thenardite.
Garnet.	Tripoli.
Gilsonite.	Trona.
Granite.	All other minerals.
Lepidolite.[3]	
Limestone.	

(b) *Definition of terms.* (1) For purposes of this section, the minerals indicated below shall have the following meanings:

(i) Clay, brick and tile—Clay used or sold for use in the manufacture of common brick, drain and roofing tile, sewer pipe, flower pots, and kindred products (other than clay specifically identified as a clay for which a 15 percent rate of percentage allowance is provided).

(ii) Clay, refractory and fire—Clay which has a pyrometric cone equivalent of 19 or higher.

(iii) Pumice—All pumice including pumicite.

(iv) Scoria—Only scoria produced from natural deposits.

(2) For purposes of this section, the term "United States" means the States and the District of Columbia. See section 7701(a)(9).

(3) For purposes of this section, the term "dimension stone" means blocks and slabs of natural stone, subsequently cut to definite shapes and sizes and used or sold for such uses as building stone (excluding rubble), monumental stone, paving blocks, curbing and flagging. For purposes of this section, "ornamental stone" means blocks and slabs of natural stone, subsequently cut to definite shapes and sizes and used or sold for use for making ornaments or statues.

(4) For purposes of this section, the term "all other minerals" does not include (i) soil, sod, dirt, turf, water, or mosses; or (ii) minerals from sea water, the air, or similar inexhaustible sources. However, the term "all other minerals" is not limited in meaning to the minerals listed in section 613(b), but includes all other minerals (except those to which a specific percentage rate applies under subparagraphs (1), (2), (3), (4), and (5) of section 613(b)): For example, gypsum, novaculite, natural mineral pigments, quartz sand and quartz pebbles, graphite and kyanite (if section 613(b)(2)(B) does not apply), and anorthosite to the extent that alumina and aluminum compounds are not extracted therefrom. The 15–percent rate applies to such "all other minerals" when used or sold for use by the mine owner or operator for purposes other than as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. When any such minerals are used or sold for use by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes, the 5–percent rate applies except that, when sold for such use by the mine owner or operator on a bid in direct competition with a bona fide bid to sell a mineral listed in section 613(b)(3), the 15-percent rate applies. For example, limestone sold on a bid in direct competition with a bona fide bid to sell rock asphalt for road building purposes may be entitled to a 15-percent rate. In every case the taxpayer must establish to the satisfaction of the district director that there was a bona fide bid to sell a mineral listed under section 613(b)(3) by a person other than the taxpayer, and that the mineral sold by the taxpayer was sold on a bid in direct competition with such bona fide bid to sell such other material.

(c) *Rules for application of paragraph (a) of this section.* (1) In no case may the allowance for depletion computed upon the basis of a percentage of gross income from the property exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For rules relating to the computation of such taxable income, see § 1.613–4.

(2) In cases in which there are produced from a mineral property two or more minerals, each entitled to a different percentage depletion rate under section 613(b) and this section, the per-

[1] Not applicable if the rate prescribed in subparagraph (2) of this paragraph is applicable.

[2] The rate prescribed in this subparagraph does not apply except to the extent that alumina and aluminum compounds are extracted therefrom.

[3] The provisions of this subparagraph are not applicable if the rate prescribed in subparagraph (2) is applicable.

[4] The 15–percent rate is applicable only to stone used or sold for use by the mine owner or operator as dimension stone or ornamental stone.

centage depletion allowance is the sum of the results obtained by applying the percentage applicable to each mineral to the "gross income from the property" attributable to such mineral. The sum so computed is subject to the limitation provided in section 613(a) and § 1.613–1, that is, 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). Such taxable income (computed in accordance with § 1.613–4) is the total taxable income resulting from the sale of all minerals produced from the mineral property. The provisions of this subparagraph may be illustrated by the following example:

Example. Pyrite, an iron sulfide, may be sold for either its sulfur content or its iron content, or both. Sulfur is entitled to a percentage depletion deduction based on 23 percent of gross income from the property whereas the percentage depletion deduction for iron is based on 15 percent of such gross income. Therefore, in the case of a taxpayer who sells pyrite for both its sulfur and iron content, 28 percent of his gross income from sulfur plus 15 percent of his gross income from iron would be his maximum allowable percentage depletion deduction. However, this maximum deduction would be subject to the limitation provided for in section 613(a), i.e., 50 percent of "taxable income from the property (computed without allowance for depletion)", such taxable income being the overall taxable income resulting from the sale of both minerals contained in the deposit.

(3) Except as provided in section 613 (d) and the regulations thereunder relating to special rules for determining rates of depletion for taxable years ending after December 31, 1953, to which the Internal Revenue Code of 1939 applies—

(i) The percentage rates set forth in this section are applicable only for taxable years beginning after December 31, 1953, and ending after August 16, 1954; and

(ii) The percentage rates set forth in 26 CFR (1939) 39.23(m)–5 (Regulations 118) are applicable for taxable years beginning before January 1, 1954, or ending before August 17, 1954.

(4) Percentage depletion is not allowable with respect to the income from a disposal of coal (including lignite) with a retained economic interest to the extent that such income is treated as from a sale of coal under section 631(c) and the regulations thereunder. Rents or royalties paid or incurred by a taxpayer with respect to coal (including lignite) shall be excluded by such taxpayer in determining "gross income from the property" without regard to the treatment under section 631(c) of such rents and royalties in the hands of the recipient.

(5) (i) In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties (which are depletable income to the payee) which are paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from "gross income from the property". The following example illustrates this rule:

Example. A leases coal-bearing lands to B on condition that B will annually pay a royalty of 25 cents a ton on coal mined and sold by B. During the year 1956, B mines and sells f.o.b. mine 100,000 tons of coal for $600,000. In computing "gross income from the property" for the year 1956, B will exclude $25,000 (100,000 tons × $0.25) in computing his allowable percentage depletion deduction. B's allowable percentage depletion deduction (without reference to the limitation based on taxable income from the property) for the year 1956 will be $57,500 (($600,000–$25,000) × 10 percent).

(ii) If bonus payments have been paid in respect of the property in any taxable year or any prior taxable years, there shall be excluded in determining the "gross income from the property", an amount equal to that part of such payments which is allocable to the product sold during the taxable year. The following example illustrates this rule:

Example. In 1956, A leases oil bearing lands to B, receiving $200,000 as a bonus and reserving a royalty of one-eighth of the proceeds of all oil produced and sold. It is estimated at the time the lease is entered into that there are 1,000,000 barrels of oil recoverable. In 1956, B produces and sells 100,000 barrels for $240,000. In computing his "gross income from the property" for the year 1956, B will exclude $30,000 (⅛ of $240,000); the royalty paid to A, and $20,000 (100,000 bbls. sold/1,000,000 bbls. estimated to be available × $200,000 bonus), the portion of the bonus allocable to the oil produced and sold during the year. However, in computing B's taxable income under section 63, the $20,000 attributable to the bonus payment shall not be either excluded or deducted from B's gross income computed under section 61. (See paragraph (a)(3) of § 1.612–3.)

(iii) If advanced royalties have been paid in respect of the property in any taxable year, the amount excluded from "gross income from the property" of the payor for the current taxable year on account of such payment shall be an amount equal to the deduction for such taxable year taken on account of such payment pursuant to paragraph (b)(3) of § 1.612–3.

Example. If B in example (2) in paragraph (b)(4) of § 1.612–3, elects to deduct in 1956 the $10,000 paid to A in that year, he must exclude the same amount from "gross income from the property" in 1956; however, if B elects to defer the deduction until 1957 when he mined and sold the mineral, he must exclude the $10,000 from "gross income from the property" in 1957.

§ 1.613–3 Gross income from the property.

(a) *Oil and gas wells.* In the case of oil and gas wells, "gross income from the property", as used in section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation.

(b) [Reserved]

(c) [Reserved]

(d) [Reserved]

(e) *Application to treat, as mining, transportation in excess of 50 miles.* If a taxpayer desires to include in the computation of his gross income from mining transportation in excess of 50 miles from the point of extraction of the minerals from the ground, he shall file an original and one copy of an application for the inclusion of such greater distance with the Commissioner of Internal Revenue, Washington 25, D.C., attention of the Special Technical Services Division, Natural Resources Branch. The application must include a statement setting forth in detail the facts concerning the physical and other requirements which prevented the construction and operation of the plant (in which ordinary treatment processes are applied) at a place nearer to the point of extraction from the ground. These facts must be sufficient to apprise the Commissioner of the exact basis of the application. If the taxpayer's return is filed prior to receipt of notice of the Commissioner's action upon the application, a copy of such application shall be attached to the return. If, after an application is approved by the Commissioner, there is a material change in any of the facts relied upon in such application, a new application must be submitted by the taxpayer.

(f) *Extraction from waste or residue.* "Extraction of ores or minerals from the ground" means not only the extraction of ores or minerals from a deposit, but also the extraction by mine owners or operators of ores or minerals from waste or residue of prior mining. The preceding sentence does not apply to any such extraction of ores or minerals by the purchaser of such waste or residue or the purchaser of the rights to extract ores or minerals from such waste or residue. The term "purchaser" does not apply to any person who acquires mineral property, including such waste or residue, in a tax-free exchange, such as a corporate reorganization, from a person who was entitled to a depletion allowance upon ores or minerals produced from such waste or residue, or from a person who would have been entitled to such depletion allowance had section 613(c)(3) been in effect at the time of the transfer. The term "purchaser" also does not apply to a lessee who has renewed a mineral lease if the lessee was entitled to a depletion allowance (or would have been so entitled had section 613(c)(3) been in effect at the time of the renewal) upon ores or minerals produced from such waste or residue before renewal of the lease. It is not necessary, for purposes of the preceding sentence, that the mineral lease contain an option for renewal. The term "purchaser" does include a person who acquires such waste or residue in a taxable transaction, even though such waste or residue is acquired merely as an incidental part of the entire mineral enterprise. It is immaterial whether the waste or residue results from the process of extraction from the ground or from application of ordinary treatment processes. However, extrac-

tion of ores or minerals from waste or residue which results from processes which are not allowable as ordinary treatment processes is not treated as mining. For special rules with respect to certain corporate acquisitions referred to in section 381(a), see section 381(c)(18) and the regulations thereunder.

§ 1.613–4 Taxable income from the property.

The term "taxable income from the property (computed without allowance for depletion)" as used in section 613 and this part, means "gross income from the property" as defined in section 613(c) and § 1.613–3, less allowable deductions (excluding any deduction for depletion) which are attributable to the mineral property, including allowable deductions attributable to ordinary treatment processes and mining transportation, with respect to which depletion is claimed. These deductions include administrative and financial overhead, operating expenses, selling expenses, depreciation, taxes, losses sustained, etc. In the case of oil and gas properties, such deductions include intangible drilling and development costs deducted under section 263(c) and § 1.612–4.[1] In the case of a property other than an oil or gas property, such deductions include deductions which are attributable to processes and transportation treated as mining under section 613(c) and § 1.613–3 and amounts of exploration or development expenditures which are deducted for the taxable year under sections 615 and 616. Expenditures which may be attributable to both the mineral property upon which depletion is claimed and other activities shall be fairly apportioned. Furthermore, where a taxpayer has more than one mineral property, deductions not directly attributable to a specific mineral property shall be fairly apportioned among the several properties.

§ 1.613–5 Statement to be attached to return when depletion is claimed on percentage basis.

In addition to the requirements set forth in paragraph (g) of § 1.611–2, a taxpayer who claims the percentage depletion deduction under section 613 for any taxable year shall attach to his return for such year a statement setting forth in complete, summary form, with respect to each property for which such deduction is allowable, the following information:

(a) All data necessary for the determination of the "gross income from the property", as defined in § 1.613–3, including—

(1) Amounts paid as rents or royalties including amounts which the recipient treats under section 631(c),

(2) Proportion and amount of bonus excluded, and

(3) Amounts paid to holders of other interests in the mineral deposit.

(b) All additional data necessary for the determination of the "taxable income from the property (computed without the allowance for depletion)", as defined in § 1.613–4.

§ 1.613–6 Application of percentage depletion rates provided in section 613 (b) to certain taxable years ending in 1954.

(a) *Election of taxpayer.* In the case of any taxable year ending after December 31, 1953, to which the Internal Revenue Code of 1939 is applicable, the taxpayer may elect in accordance with section 613(d) and this section to apply the appropriate percentage depletion rate specified in section 613 in respect of any mineral property (within the meaning of the 1939 Code). In the case of mines, wells, or other natural deposits listed in section 613(b), the election may be made by the taxpayer irrespective of whether his depletion allowance with respect to the property for the taxable year was computed upon the basis of cost, discovery value, or upon a percentage of gross income from the property. Once made, the election shall be irrevocable with respect to the property for which it is exercised. The election may be made for any mineral property of the taxpayer and need not be made for all such properties. "Gross income from the property" and "net income from the property" shall have the same meaning as those terms are used in 26 CFR (1939) 39.23(m)–1 (Regulations 118).

(b) *Computation of depletion allowance.* The depletion allowance for any taxable year with respect to any property for which the taxpayer makes the election under section 613(d) shall be an amount equal to the sum of—

(1) That portion of a tentative allowance, computed under the provisions of the Internal Revenue Code of 1939 (without regard to paragraph (1) of section 613(d)), which the number of days in the taxable year prior to January 1, 1954, bears to the total number of days in such taxable year; plus

(2) That portion of a tentative allowance, computed by using the appropriate percentage depletion rate specified in section 613(b) (but otherwise computed under the provisions of the Internal Revenue Code of 1939), which the number of days in the taxable year after December 31, 1953, bears to the total number of days in such taxable year.

In the case of any taxable year beginning after December 31, 1953, and ending before August 17, 1954, the depletion allowance with respect to any property for which the taxpayer makes the election under section 613(d) shall be computed under the provisions of the Internal Revenue Code of 1939, except that the appropriate percentage depletion rate specified in section 613(b) shall be used. In making such computation, "gross income from the property" and "net income from the property" shall be determined in the same manner as specified in paragr ph (a) of this section.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). A is a taxpayer who reports income on the basis of a taxable year ending June 30. For the taxable year ended June 30, 1954, A had gross income from a uranium property in the amount of $100,000 and his depletion allowance was computed with reference to percentage depletion. His net income from this property, for purposes of limiting the depletion allowance, was $40,000. The 15-percent rate of depletion provided for in the Internal Revenue Code of 1939 for metal mines resulted in a depletion allowance for the taxable year of $15,000. Percentage depletion computed with reference to the 23-percent rate provided for uranium under section 613(b) is $23,000 ($100,000 times 23 percent). However, the allowance computed on this basis is limited to $20,000 (50 percent of A's net income from the property). If A exercises the election provided for in section 613(d) his depletion allowance for the taxable year is the aggregate of $7,561.64 (184/365 times $15,000) plus $9,917.80 (181/365 times $20,000) or $17,479.44.

Example (2). Assume the same facts as in example (1) except that A's depletion allowance was computed on the basis of cost and amounted to $17,500. If the election is made, A's allowance for the taxable year is the aggregate of $8,821.92 (184/365 times $17,500) plus $9,917.80 (181/365 times $20,000) or $18,739.72.

(d) *Requirement for making election.* (1) The election under section 613(d) shall be made by filing a statement with the district director with whom the income tax return was filed for the taxable year to which the election is applicable. Such statement shall indicate that an election is being made under section 613(d), shall contain a recomputation of the depletion allowance and the tax liability for all taxable years affected by the exercise of the election, and shall be accompanied either by a claim for refund or credit or by an amended return or returns, whichever is appropriate.

(2) If the treatment of any item upon which a tax previously determined was based, or if the application of any provisions of the internal revenue laws with respect to such tax, depends upon the amount of income (e.g., charitable contributions, foreign tax credit, dividends received credit, and medical expenses), readjustment in these particulars will be necessary as part of any recomputation in conformity with the change in the amount of the income which results solely from the making of the election under section 613(d).

(e) *Administrative provisions; etc.* (1) Section 36(b) of the Technical Amendments Act of 1958 (72 Stat. 1633) provides as follows:

Sec. 36. Percentage depletion rates for certain taxable years ending in 1954. * * *

(b) *Statute of limitations, etc.; interest.* If refund or credit of any overpayment resulting from the application of the amendment made by subsection (a) of this section is prevented on the date of the enactment of this Act, or within 6 months from such date, by the operation of any law or rule of law (other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within 6 months from such date. No interest shall be paid on any overpayment resulting from the application of the amendment made by subsection (a) of this section.

[1] In process of preparation.

(2) If refund or credit of any overpayment resulting from the application of section 613(d) is prevented on September 2, 1958, or on or before March 2, 1959, by the operation of any law or rule of law (other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed on or before March 2, 1959. If such refund or credit is not prevented on or before March 2, 1959, the time for filing claim therefor shall be governed by the rules of law generally applicable to credits and refunds.

(3) The amount of any refund or credit which is allowable by reason of section 613(d) shall not exceed the decrease in income tax liability resulting solely from the application of the percentage rates specified in section 613(b). No interest shall be allowed or paid on any overpayment resulting from the application of section 613(d).

(4) For purposes of this section the "decrease in income tax liability" shall be the amount by which the tax previously determined (as defined in section 3801(d) of the Internal Revenue Code of 1939) exceeds the tax as recomputed under section 613(d) and this section.

(f) *Adjustment to basis.* Proper adjustment shall be made to the basis of any property as required by section 113(b)(1) of the Internal Revenue Code of 1939 and 26 CFR (1939) 39.113(b)(1)–1(c) (Regulations 118) to reflect any change in the depletion allowance resulting from the application of section 613(d) of the Internal Revenue Code of 1954.

§§ 1.614 to 1.614–4 [Reserved]

§ 1.615 Statutory provisions; exploration expenditures.

SEC. 615. *Exploration expenditures*—(a) *In general.* In the case of expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, and paid or incurred before the beginning of the development stage of the mine or deposit, there shall be allowed as a deduction in computing taxable income so much of such expenditures as does not exceed $100,000. This section shall apply only with respect to the amount of such expenditures which, but for this section, would not be allowable as a deduction for the taxable year. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures paid or incurred. In no case shall this section apply with respect to amounts paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of oil or gas.

(b) *Election of taxpayer.* If the taxpayer elects, in accordance with regulations prescribed by the Secretary or his delegate, to treat as deferred expenses any portion of the amount deductible for the taxable year under subsection (a), such portion shall not be deductible in the manner provided in subsection (a) but shall be deductible on a ratable basis as the units of produced ores or minerals discovered or explored by reason of such expenditures are sold. An election made under this subsection for any taxable year shall be binding for such year.

(c) *Limitation.* This section shall not apply to any amount paid or incurred in any taxable year if in any 4 preceding years a deduction or election under this section, or the corresponding provision of prior laws, has been allowed to, or exercised by—

(1) The taxpayer, or

(2) The individual or corporation who has transferred to the taxpayer any mineral property.

Paragraph (2) shall apply only if (A) the taxpayer was required to take into account under section 23(ff)(3) of the Internal Revenue Code of 1939 the deduction allowed to or election exercised by such individual or corporation; (B) the taxpayer would be entitled under section 381(c)(10) to deduct expenses deferred under this section had the distributor or transferor corporation elected to defer such expenses; or (C) the taxpayer acquired any mineral property under circumstances which make section 334(b), 362 (a) and (b), 372(a), 373(b)(1), 723, 732, 1051, or 1082 apply to such transfer.

(d) *Adjusted basis of mine or deposit.* The amount of expenditures which are treated under subsection (b) as deferred expenses shall be taken into account in computing the adjusted basis of the mine or deposit, but such amounts, and the adjustments to basis provided in section 1016(a)(10) shall be disregarded in determining the adjusted basis of the property for the purpose of computing a deduction for depletion under section 611.

§ 1.615–1 Exploration expenditures.

(a) *General rule.* Section 615 prescribes rules for the treatment of expenditures for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (other than oil or gas) paid or incurred by the taxpayer before the beginning of the development stage of the mine or other natural deposit. The development stage of the mine or other natural deposit will be deemed to begin at the time when, in consideration of all the facts and circumstances (including the actions of the taxpayer), deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. Such expenditures hereinafter in the regulations under section 615 will be referred to as exploration expenditures. Under section 615(a), a taxpayer may, at his option, deduct exploration expenditures paid or incurred in an amount not to exceed $100,000 for any taxable year. Under section 615(b) and § 1.615–2 he may elect to defer any part of such amount and deduct such part on a ratable basis as the minerals benefited by such expenditures are sold. In any taxable year in which the taxpayer does not treat exploration expenditures under either of these methods, they will be charged to depletable capital account. The option to deduct under section 615(a), and the election to defer under section 615(b), may be exercised in only four taxable years as provided in section 615(c) and § 1.615–4.

(b) *Expenditures to which section 615 is not applicable.* (1) Section 615 is not applicable to expenditures which would be allowed as a deduction for the taxable year without regard to such section.

(2) Section 615 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowances for depreciation of such improvements which are used in the exploration of ores or minerals are considered exploration expenditures under section 615. If such improvements are used only in part for exploration during a taxable year, an allocable portion of the allowance for depreciation shall be treated as an exploration expenditure.

(3) Section 615 is applicable to exploration expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired by the taxpayer. The expenditures attributable to the remaining fractional share shall be considered as the cost of his acquired interest and shall be recovered through depletion allowances. For example, taxpayer A owns mineral leases on unexplored mineral lands and agrees to convey an undivided three-fourths (¾) interest in such leases to taxpayer B provided B will pay all of the exploration expenditures for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral which will be incurred before the beginning of the development stage. B shall treat three-fourths of such amount under section 615, and shall treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) The provisions of section 615 do not apply to costs of exploration which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Such provisions apply only to costs paid or incurred by the taxpayer for exploration undertaken directly or through a contract by the taxpayer. See, however, sections 381(a) and 381(c)(10) for special rules with respect to deferred exploration expenditures in certain corporate acquisitions.

§ 1.615–2 Deduction of exploration expenditures in the year paid or incurred.

(a) *In general.* (1) Subject to the total limitation of $100,000, a taxpayer who has made exploration expenditures with respect to more than one mine or other natural deposit may deduct in a taxable year any portion of the expenditures attributable to each such mine or deposit. With respect to a particular mine or other natural deposit, the taxpayer may deduct a portion of the exploration expenditures under section 615(a) and may defer and deduct the balance of such expenditures under section 615(b). He must charge to capital account any amount in excess of $100,000 in any taxable year and he must charge to capital account whatever amount has not been deducted currently or deferred. For example, taxpayer A has three mines, X, Y, and Z. In the taxable year 1957, A makes exploration expenditures of $75,000 with respect to each mine. The total allowable deduction for exploration expenditures is $100,000. A deducts $50,000 and defers

$25,000 with respect to X. He deducts $25,000, and charges to capital account $50,000 with respect to Y, and charges to capital account the entire $75,000 paid with respect to Z. Thus, A has deducted or deferred $100,000, and capitalized the excess.

(2) The taxpayer cannot change his treatment of exploration expenditures for any taxable year after the due date (including extensions of time) for filing the return for such taxable year except where it is subsequently determined that any part of such exploration expenditures deducted under section 615(a) or deferred under section 615(b) are not exploration expenditures for the taxable year. In such case, exploration expenditures required to be charged to capital account for such taxable year by reason of the limitation may be deducted or deferred (to the extent of the subsequent determination) and proper adjustment made to capital account. A taxpayer claiming a deduction under section 615(a) shall indicate clearly on his income tax return the amount of the deduction claimed under such section with respect to each mine or other natural deposit. Such mine or deposit shall be identified by an adequate description.

§ 1.615–3 Election to defer exploration expenditures.

(a) *General rule.* A taxpayer may defer any portion of the exploration expenditures made with respect to each mine or other natural deposit, subject to the limitations of time and amount described in section 615(c) and § 1.615–4. The amounts so deferred shall be deducted ratably as the units of the ores or minerals discovered or explored by reason of such expenditures are sold.

(b) *Effect and manner of making election.* (1) The election to defer exploration expenditures shall apply only to expenditures for the taxable year for which made. However, once made, the election shall be binding with respect to the expenditures for that taxable year. Thus, a taxpayer cannot revoke his election for any reason whatsoever.

(2) The election shall be made for each mine or other natural deposit by a clear indication on the return or by a statement filed with the district director with whom the return was filed, not later than the time prescribed by law for filing such return (including extensions thereof) for the taxable year to which such election is applicable.

(c) *Expenditures made by the owner who retains a non-operating mineral interest.* (1) A taxpayer who elects to defer exploration expenditures and thereafter transfers his interest in the mine or other natural deposit, retaining an economic interest therein, shall deduct an amount attributable to such interest on a pro rata basis as the interest pays out. For example, a taxpayer who defers exploration expenditures and then leases his deposit, retaining a royalty interest therein, shall deduct the deferred expenditures ratably as he receives royalties. If the taxpayer receives a bonus or advanced royalties in connection with the transfer of his interest, he shall deduct deferred expenditures allocable to such bonus or advanced royalties in an amount which is in the same proportion to the total of such costs as the bonus or advanced royalties bears to the bonus and total royalties expected to be received. Also, in the case of a transfer of a mine or other natural deposit by a taxpayer who retains a production payment therein, he shall deduct the exploration expenditures ratably over the payments expected to be received.

(2) Where a taxpayer receives an amount, in addition to retaining an economic interest, which amount is treated as from the sale or exchange of a capital asset or property treated under section 1231 (except coal to which section 631(c) applies), the deferred exploration expenditures shall be allocated between the interest sold and the interest retained in proportion to the fair market values of each interest as of the date of sale. The amount allocated to the interest sold may not be deducted, but shall be a part of the basis of such interest.

(d) *Losses from abandonment.* Section 165 and the regulations thereunder contain general rules relating to the treatment of losses resulting from abandonment.

(e) *Computation of amount of deduction.* The amount of the deduction allowable during the taxable year is an amount A, which bears the same ratio to B (the total deferred exploration expenditures for a particular mine or other natural deposit reduced by the amount of such expenditures deducted in prior taxable years) as C (the number of units of the ore or mineral benefited by such expenditures sold during the taxable year) bears to D (the number of units of ore or mineral benefited by such expenditures remaining as of the taxable year). For the purposes of this proportion, the "number of units of ore or mineral benefited by such expenditures remaining as of the taxable year" is the number of units of ore or mineral benefited by the deferred exploration expenditures remaining at the end of the year to be recovered from the mine or other natural deposit (including units benefited by such expenditures recovered but not sold) plus the number of units benefited by such expenditures sold within the taxable year. The principles outlined in § 1.611–2 are applicable in estimating the number of units remaining as of the taxable year and the number of units sold during the taxable year. The estimate is subject to revision in accordance with that section in the event it is ascertained from any source, such as operations or development work, that the remaining units are materially greater or less than the number of units remaining from a prior estimate.

§ 1.615–4 Limitation of amount deductible.

(a) *In general.* In any taxable year a taxpayer may deduct or defer exploration expenditures, to which section 615 is applicable, in an amount not in excess of $100,000. The taxpayer may avail himself of the provisions of section 615 in any four taxable years (including taxable years of less than 12 months and taxable years subject to the Internal Revenue Code of 1939. Such four taxable years need not be consecutive. In determining the number of years in which a taxpayer has availed himself of section 615, a year for which he makes an election to defer exploration expenditures shall count as one year. Any subsequent taxable year in which such deferred expenditures are deducted shall not be taken into account as one of the four years. For purposes of the 4-year limitation, a year in which both a deduction and an election to defer are availed of shall be taken into account as only one year.

(b) *Transferee of mineral property.* (1) The taxpayer shall take into account for purposes of the 4-year limitation any year in which an individual or corporation, who has transferred any mineral property to him, has previously deducted or deferred exploration expenditures under section 615, or section 23(ff) of the Internal Revenue Code of 1939, provided any of the following subdivisions of this subparagraph are applicable:

(i) The taxpayer under section 23(ff) of the Internal Revenue Code of 1939 was required to take into account a taxable year in which his transferor was allowed the deduction or exercised the election to defer.

(ii) The taxpayer would be entitled under section 381(c)(10) to deduct exploration expenditures if the transferor (or distributor) corporation had elected to defer such expenditures. For example, if the taxpayer acquired any mineral property in a transaction described in section 381(a) (relating to the acquisition of assets through certain corporate liquidations and reorganizations), the years in which the transferor exercised the election to defer or deduct exploration expenditures shall be taken into account in computing the taxpayer's 4-year limitation. For a further limitation, see section 381(c)(10).

(iii) The taxpayer acquired any mineral property under circumstances which make applicable the following sections of the Code:

(*a*) Section 334(b)(1), relating to the liquidation of a subsidiary where the basis of the property in the hands of the distributee is the same as it would be in the hands of the transferor.

(*b*) Section 362 (a) and (b), relating to property acquired by a corporation as paid-in surplus or as a contribution to capital, or in connection with a transaction to which section 351 applies.

(*c*) Section 372(a), relating to reorganization in certain receiverships and bankruptcy proceedings.

(*d*) Section 373(b)(1), relating to property of a railroad corporation acquired in certain bankruptcy or receivership proceedings.

(*e*) Section 1051, relating to property acquired by a corporation that is a member of an affiliated group.

(*f*) Section 1082, relating to property acquired pursuant to a Securities Exchange Commission order.

(2) For purposes of subparagraph (1) of this paragraph, it is immaterial whether or not a deduction has been allowed or an election has been made by the transferor with respect to the specific mineral property transferred.

(3) Where a mineral property is acquired under any circumstance except those described in subparagraph (1) of this paragraph, the taxpayer is not required to take into account the election exercised by or deduction allowed to his transferor.

(4) For purposes of applying the limitations imposed by section 615(c), the partner, and not the partnership, shall be considered as the taxpayer. See paragraph (a)(8)(iii) of § 1.702–1.

(5) The application of the provisions of paragraph (b) of this section may be illustrated by the following examples:

Example (1). Assume that a taxpayer who has never claimed the benefits of section 615 received in 1956 a mineral deposit from X Corporation upon a distribution in complete liquidation of the latter under conditions which would make the provisions of section 334(b)(1) applicable in determining the basis of the property in the hands of the taxpayer, and that during the year 1955 X Corporation expended $60,000 for exploration expenditures which X Corporation elected to treat as deferred expenses. On the basis of these facts, the taxpayer may deduct or defer for any three (not necessarily consecutive) subsequent taxable years exploration expenditures made in those years not to exceed $100,000 in any year.

Example (2). Assume the same facts stated in example (1) except that, prior to acquisition by the taxpayer of the deposit from corporation X in 1956, corporation X had acquired the deposit in 1954 in a similar distribution from Y Corporation which, in the years 1952 and 1953, deducted exploration costs paid in respect of an entirely different deposit in the amount of $30,000 and $50,000, respectively. Under these circumstances, the taxpayer may deduct or defer exploration expenditures paid or incurred for only one taxable year in an amount not in excess of $100,000.

Example (3). In 1957, A and B transfer assets to a corporation under circumstances making section 351 applicable to such a transfer. Among the assets transferred by A is a mineral lease with respect to certain coal lands. A has deducted exploration expenditures under section 615 for the years 1954 and 1956 made with respect to other deposits not included in the transfer to the corporation. The corporation shall be charged with the two years previously used by A and may avail itself of the provisions of section 615 for only two additional years.

Example (4). In 1956, A, B, and C form a partnership for the purpose of exploring for, developing, and producing uranium. A contributes a uranium lease to the partnership. A has individually made exploration expenses with respect to other mineral properties not contributed to the partnership and which he has deducted under section 615(a) for the years 1954 and 1955. B contributes a uranium lease to the partnership on which he made exploration expenditures in 1955 which he elected to defer under section 615(b). This is the only year in which B has used section 615. C contributes only cash to the partnership and has not previously used section 615. Subject to the limitation of section 615, A may deduct or defer exploration expenses for two more taxable years (either as to expenditures incurred by him individually or with respect to his distributive share of partnership exploration expenses). B may similarly deduct or defer exploration expenditures for three more years. C may deduct or defer exploration expenditures for four years.

§ 1.615–5 Time for making election with respect to returns due on or before May 2, 1960.

In the case of any taxable year beginning after December 31, 1953, and ending after August 16, 1954, the income tax return for which is due not later than May 2, 1960, the time for exercising any option or making any election under section 615 shall expire on May 2, 1960.

§ 1.616 Statutory provisions; development expenditures.

SEC. 616. *Development expenditures*—(a) *In general.* Except as provided in subsection (b), there shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures.

(b) *Election of taxpayer.* At the election of the taxpayer, made in accordance with regulations prescribed by the Secretary or his delegate, expenditures described in subsection (a) paid or incurred during the taxable year shall be treated as deferred expenses and shall be deductible on a ratable basis as the units of produced ores or minerals benefited by such expenditures are sold. In the case of such expenditures paid or incurred during the development stage of the mine or deposit, the election shall apply only with respect to the excess of such expenditures during the taxable year over the net receipts during the taxable year from the ores or minerals produced from such mine or deposit. The election under this subsection, if made, must be for the total amount of such expenditures, or the total amount of such excess, as the case may be, with respect to the mine or deposit, and shall be binding for such taxable year.

(c) *Adjusted basis of mine or deposit.* The amount of expenditures which are treated under subsection (b) as deferred expenses shall be taken into account in computing the adjusted basis of the mine or deposit, except that such amount, and the adjustments to basis provided in section 1016(a)(9), shall be disregarded in determining the adjusted basis of the property for the purpose of computing a deduction for depletion under section 611.

§ 1.616–1 Development expenditures.

(a) *General rule.* Section 616 prescribes rules for treating expenditures paid or incurred during the taxable year by the taxpayer for the development of a mine or other natural deposit (other than an oil or gas well). Development expenditures under section 616 are those which are made after such time when, in consideration of all the facts and circumstances (including actions of the taxpayer), deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. Under section 616(a), a taxpayer is allowed a deduction for development expenditures whether or not such expenditures are made in the development or production stage of the mine or other natural deposit. Under section 616(b), the taxpayer may elect to defer development expenditures made in the development or producing stage and to deduct such expenditures ratably as the minerals or ores benefited are sold. While the mine or other natural deposit is in the development stage, the election applies only to that portion of the development expenditures which is in excess of net receipts from the mine or other natural deposit. See § 1.616–2 for rules with respect to the election to defer. It is not necessary that the taxpayer incur the development costs directly. He may engage a contractor to make the expenditures on his behalf.

(b) *Expenditures to which section 616 is not applicable.* (1) Section 616 is not applicable to development expenditures which are deductible for the taxable year under any other provision of the internal revenue laws.

(2) Section 616 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowance for depreciation of such improvements which are used in the development of ores or minerals are considered development expenditures under section 616. If such improvements are used only in part for development during a taxable year, an allocable portion of the allowance for depreciation shall be treated as a development expenditure.

(3) Section 616 is applicable to development expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired. The expenditure attributable to the remaining fractional share shall be considered as part of the cost of his acquired interest and shall be capitalized and recovered through depletion allowances. For example, taxpayer A owns mineral leases on undeveloped mineral lands. A agrees to convey an undivided three-fourths (¾) interest in such leases to B, provided B will pay all of the expenditures incurred during the development stage of the deposits on these leases. B may deduct three-fourths (¾) of such amount under section 616, but shall treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) The provisions of section 616 do not apply to costs of development paid or incurred by a prior owner which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Such provisions apply only to costs paid or incurred by the taxpayer for development undertaken directly or through contract by the taxpayer. See, however, section 381(a) and 381(c)(10) for special rules with respect to deferred development expenditures in certain corporate acquisitions.

(c) *Mine or other natural deposit.* Section 616 has reference to expenditures made for the development of a mine or other natural deposit. Within an aggregated property, as that term is defined in section 614 (b) and (c), or within a single tract or parcel of land, there may be more than one mine or other natural deposit. Where a property, as determined under section 614, contains more than one mine or other natural deposit, the taxpayer may deduct under section 616(a) the development expenditures

made with respect to one of such mines or deposits, and may defer under section 616(b) the development expenditures made with respect to another of such mines or deposits. Where there is more than one mine with respect to a single underlying deposit, the taxpayer may deduct under section 616(a) the development expenditures made with respect to one of such mines, and may defer under section 616(b) the development expenditures made with respect to another of such mines. The taxpayer must treat consistently all development expenditures with respect to each such mine or other natural deposit in a taxable year. The taxpayer must make a separate determination of the units of minerals or ores benefited in a mine or other natural deposit (regardless of the computation of the depletion allowance) in order that deferred expenditures with respect to such mine or deposit may be deducted on a ratable basis. See paragraph (f) of § 1.616–2.

§ 1.616–2 Election to defer.

(a) *General rule.* In lieu of taking a deduction under section 616(a), in the taxable year when the development expenditures are paid or incurred, a taxpayer may elect under section 616(b) to treat such expenditures with respect to each mine or other natural deposit as deferred expenses to be deducted ratably as the units of the produced ore or minerals benefited by such expenditures are sold. Section 616(b) is applicable to development expenditures paid or incurred both in the development and producing stage of the mine or other natural deposit. However, in the case of such expenditures made in the development stage, this election is applicable only to the excess of the amount of such expenditures over the net receipts from the ore or minerals from such mine or deposit received or accrued during the development stage and in the same taxable year as the expenditures were paid or incurred. Such development expenditures not in excess of such net receipts shall be subject to the provisions of section 616(a).

(b) *Producing stage; definition of.* The mine or other natural deposit will be considered to be in a producing stage when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine or other natural deposit is the production of developed ores or minerals rather than the development of additional ores or minerals for mining.

(c) *Expenditures made by the owner who retains a nonoperating interest.* (1) A taxpayer who elects to defer development expenditures and thereafter transfers his interest in the mine or other natural deposit, retaining an economic interest therein, shall deduct an amount attributable to such interest on a pro rata basis as the interest pays out. For example, a taxpayer who defers development expenditures and then leases his deposit, retaining a royalty interest therein, shall deduct the deferred expenditures ratably as he receives the royalties. If the taxpayer receives a bonus or advanced royalties in connection with the transfer of his interest, he shall deduct the deferred expenditures allocable to such bonus or advanced royalties in an amount which is in the same proportion to the total of such costs as the bonus or advanced royalties bears to the bonus and total royalties expected to be received. Also, in the case of a transfer of a mine or other natural deposit by a taxpayer who retains a production payment therein, he may deduct the development expenditures ratably over the payments expected to be received.

(2) Where a taxpayer receives an amount, in addition to retaining an economic interest, which amount is treated as from the sale or exchange of a capital asset or property treated under section 1231 (except coal to which section 631(c) applies), the deferred development expenditures shall be allocated between the interest sold and the interest retained in proportion to the fair market value of each interest as of the date of sale. The amount allocated to the interest sold may not be deducted, but shall be a part of the basis of such interest for the purpose of determining gain or loss upon the sale thereof.

(d) *Losses from abandonment.* Section 165 and the regulations thereunder contain general rules relating to the treatment of losses resulting from abandonment.

(e) *Effect of election.* (1) The election to defer development expenditures shall apply only to expenditures for the taxable year for which made. However, once made, the election shall be binding with respect to the expenditures for that taxable year. Thus, a taxpayer cannot revoke his election for any reason whatsoever.

(2) The election shall be made for each mine or other natural deposit by a clear indication on the return or by a statement filed with the district director with whom the return was filed, not later than the time prescribed by law for filing such return (including extensions thereof) for the taxable year to which such election is applicable.

(f) *Computation of amount of deduction.* The amount of the deduction allowable during the taxable year is an amount A, which bears the same ratio to B (the total deferred development expenditures for a particular mine or other natural deposit reduced by the amount of such expenditures deducted in prior taxable years) as C (the number of units of the ore or mineral benefited by such expenditures sold during the taxable year) bears to D (the number of units of ore or mineral benefited by such expenditures remaining as of the taxable year). For the purposes of this proportion, the "number of units of ore or mineral benefited by such expenditures remaining as of the taxable year" is the number of units of ore or mineral benefited by the deferred development expenditures remaining at the end of the year to be recovered from the mine or other natural deposit (including units benefited by such expenditures recovered but not sold) plus the number of units benefited by such expenditures sold within the taxable year. The principles outlined in § 1.611–2 are applicable in estimating the number of units remaining as of the taxable year and the number of units sold during the taxable year. The estimate is subject to revision in accordance with that section in the event it is ascertained, from any source, such as operations or development work, that the remaining units are materially greater or less than the number of units remaining from a prior estimate.

§ 1.616–3 Time for making election with respect to returns due on or before May 2, 1960.

In the case of any taxable year beginning after December 31, 1953, and ending after August 16, 1954, the income tax return for which is due not later than May 2, 1960, the time to deduct or defer development expenditures for such a year under section 616 (a) or (b) shall expire on May 2, 1960.

Exclusions From Gross Income

§ 1.621 Statutory provisions; payments to encourage exploration, development, and mining for defense purposes.

SEC. 621. *Payments to encourage exploration, development, and mining for defense purposes.* There shall not be included in gross income any amount paid to a taxpayer by the United States (or any agency or instrumentality thereof), whether by grant or loan, and whether or not repayable, for the encouragement of exploration, development, or mining of critical and strategic minerals or metals pursuant to or in connection with any undertaking approved by the United States (or any of its agencies or instrumentalities) and for which an accounting is made or required to be made to an appropriate governmental agency, or any forgiveness or discharge of any part of such amount. Any expenditures (other than expenditures made after the repayment of such grant or loan) attributable to such grant or loan shall not be deductible by the taxpayer as an expense nor increase the basis of the taxpayer's property either for determining gain or loss on sale, exchange, or other disposition or for computing depletion or depreciation, but on the repayment of any portion of any such grant or loan which has been expended in accordance with the terms thereof such deductions and such increases in basis shall to the extent of such repayment be allowed as if made at the time of such repayment.

§ 1.621–1 Payments to encourage exploration, development, and mining for defense purposes.

(a) *General rule.* (1) Under section 621, a taxpayer shall exclude from gross income amounts which are paid to him:

(i) By the United States or by an agency or instrumentality of the United States,

(ii) As a grant, gift, bounty, bonus, premium, incentive, subsidy, loan, or advance,

(iii) For the encouragement of exploration for, or development or mining of, a critical and strategic mineral or metal,

(iv) Pursuant to or in connection with an undertaking by the taxpayer to explore for, or develop or produce, such mineral or metal and to expend or use any amounts so received for the purpose and in accordance with the terms and conditions upon which such amounts are paid, which undertaking has been ap-

proved by the United States or by an agency or instrumentality of the United States, and

(v) For which the taxpayer has accounted, or is required to account, to an appropriate agency of the United States Government for the expenditure or use thereof for the purpose and in accordance with the terms and conditions upon which such amounts are paid.

In order for section 621 to apply, such amount must qualify under each of the foregoing subdivisions of this paragraph. Under section 621, there shall also be excluded from gross income any income attributable to the forgiveness or discharge of any indebtedness arising from amounts to which such section applies.

(2) Section 621 is applicable whether or not the payee is obligated to repay to the United States any portion or all of the amount so received. However, such section is not applicable to any loan or advance for the repayment of which the borrower's liability is unconditional and legally enforceable.

(3) Except as provided in paragraph (e) of this section any expenditure attributable to an amount received by a taxpayer to which section 621 applies shall not be deductible by the taxpayer as an expense under subtitle A of the Code, nor shall any such expenditure increase the basis of the taxpayer's property either for determining gain or loss on sale, exchange, or other disposition, or for computing depletion or depreciation (including amortization under section 168).

(b) *Allowance as part of purchase price.* (1) Section 621 is not applicable to any part of the purchase price of a critical and strategic mineral or metal which amount is received, whether before, on, or after delivery from the United States or any agency or instrumentality thereof, and irrespective of whether such purchase price is below, at, or above the currently prevailing market price.

(2) However, a payment of a separate and specific amount for the encouragement of exploration for, or development or mining of, a critical and strategic mineral or metal shall not be considered to be a part of the purchase price of such mineral or metal merely because such payment is added to, or included with, the payment of such purchase price.

(c) *Payments for expenditures previously deducted or capitalized.* (1) Where amounts described in section 621 and this section are paid to a taxpayer in reimbursement for expenditures previously allowed as a deduction, the taxpayer shall include in gross income that portion of such amounts which is equivalent to the deduction for such expenditures allowed to the taxpayer and which deduction resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws.

(2) Where amounts described in section 621 and this section are paid to the taxpayer in reimbursement for expenditures which have been deferred under sections 615 and 616 (relating to exploration and development expenditures) the taxpayer shall include in gross income that portion of such amounts which is equivalent to any deduction for such expenditures allowed to the taxpayer and which deduction resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws. The portion of such amounts equivalent to expenditures which are reflected in the adjusted basis of the assets to which charged, shall be excluded from gross income, and such adjusted basis shall be decreased by the amount of such exclusion.

(3) Where amounts described in section 621 and this section are paid to the taxpayer in reimbursement for expenditures which have been charged to capital account (either to a depletable or depreciable account), there shall be included in the taxpayer's gross income that portion of such amounts which is equivalent to such capital expenditures that have been recovered through cost depletion or depreciation deductions and which deductions have resulted in a reduction of the taxpayer's taxes for any taxable year under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws. The portion of such amounts which is equivalent to the expenditures which are reflected in the adjusted basis of the asset to which charged shall be excluded from gross income. The adjusted basis of such assets shall be reduced by the amount of such exclusion from gross income.

(4) Where amounts described in section 621 and this section are paid to the taxpayer in reimbursement for expenditures which have been charged to a depletable capital account, such amounts shall be excluded to the extent such expenditures are recovered through depletion deductions computed under section 613 (relating to percentage depletion).

(5) The amount of reimbursed expenditures charged to an account (depletable or depreciable) and recovered through depletion or depreciation deductions for any taxable year shall be that proportion of the total deductions allowed with respect to such account that such reimbursed expenditures bear to the total amount in the account. For example, in 1956 A incurs exploration expenditures of $12,000 which he charges to a depletable capital account. This brings the total amount in this account to $36,000 which is the adjusted basis of the property on January 1, 1957. In 1957, A is allowed a deduction for cost depletion of $9,000 which resulted in a reduction of A's income taxes. One-third of this deduction is attributable to the $12,000 of exploration expenditures since they were a third of the total in the capital account on January 1, 1957. Therefore, on January 1, 1958, these exploration expenditures make up $9,000 of the remaining $27,000 in the account. If on January 1, 1958, A receives $12,000, which qualifies under section 621, in reimbursement for these exploration expenditures, he must report $3,000 as income and reduce the capital account by $9,000.

(d) *Definition.* As used in section 621 and this section, the term "critical and strategic minerals or metals" means minerals and metals which are considered by those departments, agencies, and instrumentalities of the United States charged with the encouragement of exploration for, and development and mining of, critical and strategic minerals and metals, to constitute critical and strategic minerals and metals for defense purposes. See, for example, 30 CFR 301.3 (Regulations for Obtaining Federal Assistance in Financing Explorations for Mineral Reserves, Excluding Organic Fuels, in the United States, its Territories and Possessions).

(e) *Repayments of amounts excluded under section 621.* Upon the repayment by the taxpayer of any portion of any amount to which section 621 applies and which portion has been expended for the purpose and in accordance with the terms and conditions upon which it was paid to the taxpayer, any expenditures attributable to such amount made by the taxpayer shall be treated as if such expenditures had been made at the time of such repayment. Such expenditures shall to the extent of the repayment be expensed or capitalized, as the case may be, in the order in which they were actually made or in such other manner as may be adopted by the taxpayer with the approval of the Commissioner.

SALES AND EXCHANGES

§ 1.631 Statutory provisions; gain or loss in the case of timber or coal.

SEC. 631. *Gain or loss in the case of timber or coal*—(a) *Election to consider cutting as sale or exchange.* If the taxpayer so elects on his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 6 months before the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber, and the adjusted basis for depletion of such timber in the hands of the taxpayer. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this subsection, such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding on the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Secretary or his delegate, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this subsection except with the consent of the Secretary or his delegate. For purposes of this subsection and subsection (b), the term "timber" includes evergreen trees which are more than

6 years old at the time severed from the roots and are sold for ornamental purposes.

(b) *Disposal of timber with a retained economic interest.* In the case of the disposal of timber held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. The date of disposal of such timber shall be deemed to be the date such timber is cut, but if payment is made to the owner under the contract before such timber is cut the owner may elect to treat the date of such payment as the date of disposal of such timber. For purposes of this subsection, the term "owner" means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber.

(c) *Disposal of coal with a retained economic interest.* In the case of the disposal of coal (including lignite), held for more than 6 months before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal, the difference between the amount realized from the disposal of such coal and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such coal. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal. This subsection shall not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal, and the word "owner" means any person who owns an economic interest in coal in place, including a sublessor. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determinations of the amount of the deductions under section 535 (b) (6) or section 545 (b) (5)).

§ 1.631–1 Election to consider cutting as sale or exchange.

(a) *Effect of election.* (1) Section 631 (a) provides an election to certain taxpayers to treat the difference between the actual cost or other basis of certain timber cut during the taxable year and its fair market value as standing timber on the first day of such year as gain or loss from a sale or exchange under section 1231. Thereafter, any subsequent gain or loss shall be determined in accordance with paragraph (e) of this section.

(2) For the purposes of section 631 (a) and this section, timber shall be considered cut at the time when in the ordinary course of business the quantity of timber felled is first definitely determined.

(3) The election may be made with respect to any taxable year even though such election was not made with respect to a previous taxable year. If an election has been made under the provisions of section 631 (a), or corresponding provisions of prior internal revenue laws, such election shall be binding upon the taxpayer not only for the taxable year for which the election is made but also for all subsequent taxable years, unless the Commissioner on showing by the taxpayer of undue hardship permits the taxpayer to revoke his election for such subsequent taxable years. If the taxpayer has revoked a previous election, such revocation shall preclude any further elections unless the taxpayer obtains the consent of the Commissioner.

(4) Such election shall apply with respect to all timber which the taxpayer has owned, or has had a contract right to cut, for a period of more than six months prior to the beginning of the taxable year in which such timber is cut for sale or for use in the taxpayer's trade or business, irrespective of whether such timber or contract right was acquired before or after the election. (For purposes of the preceding sentence, the rules with respect to the holding period of property contained in section 1223 shall be applicable.) However, timber which is not cut for sale or for use in the taxpayer's trade or business (for example, firewood cut for the taxpayer's own household consumption) shall not be considered to have been sold or exchanged upon the cutting thereof.

(b) *Who may make election.* (1) A taxpayer who has owned, or has held a contract right to cut, timber for a period of more than six months before the beginning of the taxable year may elect under section 631 (a) to consider the cutting of such timber during such year for sale or for use in the taxpayer's trade or business as a sale or exchange of the timber so cut. In order to have a "contract right to cut timber" within the meaning of section 631 (a) and this section, a taxpayer must have a right to sell the timber cut under the contract on his own account or to use such cut timber in his trade or business.

(2) For purposes of section 631 (a) and this section, the term "timber" includes evergreen trees which are more than six years old at the time severed from their roots and are sold for ornamental purposes, such as Christmas decorations. Section 631 (a) is not applicable to evergreen trees which are sold in a live state, whether or not for ornamental purposes. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631 (a). The term "evergreen trees" is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

(c) *Manner of making election.* The election under section 631 (a) must be made by the taxpayer in his income tax return for the taxable year for which the election is applicable, and such election cannot be made in an amended return for such year. The election in the return shall take the form of a computation under the provisions of section 631 (a) and section 1231.

(d) *Computation of gain or loss under the election.* (1) If the cutting of timber is considered as a sale or exchange pursuant to an election made under section 631 (a), gain or loss shall be recognized to the taxpayer in an amount equal to the difference between the adjusted basis for depletion in the hands of the taxpayer of the timber which has been cut during the taxable year and the fair market value of such timber as of the first day of the taxable year in which such timber is cut. The adjusted basis for depletion of the cut timber shall be based upon the number of units of timber cut during the taxable year which are considered to be sold or exchanged and upon the depletion unit of the timber in the timber account or accounts pertaining to the timber cut, and shall be computed in the same manner as is provided in section 611 and the regulations thereunder with respect to the computation of the allowance for depletion.

(2) The fair market value of the timber as of the first day of the taxable year in which such timber is cut shall be determined, subject to approval or revision by the district director upon examination of the taxpayer's return, by the taxpayer in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, methods of exploitation, degree of utilization, etc. The value sought will be the selling price, assuming a transfer between a willing seller and a willing buyer as of that particular day. Due consideration will be given to the factors and the principles involved in the determination of the fair market value of timber as described in the regulations under section 611.

(3) The fair market value as of the beginning of the taxable year of the standing timber cut during the year shall be considered to be the cost of such timber, in lieu of the actual cost or other basis of such timber, for all purposes for which such cost is a necessary factor. See paragraph (e) of this section.

(4) For any taxable year for which the cutting of timber is considered to be a sale or exchange of such timber under section 631 (a), the timber so cut shall be considered as property used in the trade or business for the purposes of section 1231, along with other property of the taxpayer used in the trade or business as defined in section 1231 (b), regardless of whether such timber is property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether the gain or loss considered to have resulted from the cutting of the timber will be considered to be gain or loss resulting from the sale or exchange of capital assets held for more than six months depends upon the application of section 1231 to the taxpayer for the taxable year. See section 1231 and the regulations thereunder.

(e) *Computation of subsequent gain or loss.* (1) In case the products of the timber are sold after cutting, either in

the form of logs or lumber or in the form of manufactured products, the income from such actual sales shall be considered ordinary income. When the election under section 631 (a) is in effect, the cost of standing timber cut during the taxable year is determined as if the taxpayer had purchased such timber on the first day of the taxable year. Thus, in determining the cost of the products so sold, the cost of the timber shall be the fair market value on the first day of the taxable year in which the standing timber was cut, in lieu of the actual cost or other basis of such timber.

(2) This is also the rule in case the products of the timber cut during one taxable year, with respect to which an election has been made under section 631 (a), are sold during a subsequent taxable year, whether or not the election provided in section 631 (a) is applicable with respect to such subsequent year. If the products of the timber cut during a taxable year with respect to which an election under section 631 (a) was made were not sold during such year and are included in inventory at the close of such year, the fair market value as of the beginning of the year of the timber cut during the year shall be used in lieu of the actual cost of such timber in computing the closing inventory for such year and the opening inventory for the succeeding year. With respect to the costs applicable in the determination of the amount of such inventories, there shall be included the fair market value of the timber cut, the costs of cutting, logging, and all other expenses incident to the cost of converting the standing timber into the products in inventory. See section 471 and the regulations thereunder. The fact that the fair market value as of the first day of the taxable year in which the timber is cut is deemed to be the cost of such timber shall not preclude the taxpayer from computing its inventories upon the basis of cost or market, whichever is lower, if such is the method used by the taxpayer. Nor shall it preclude the taxpayer from computing its inventories under the last-in, first-out inventory method provided by section 472 if such section is applicable to, and has been elected by, the taxpayer.

§ 1.631–2 Gain or loss upon the disposal of timber under cutting contract.

(a) *In general.* (1) If an owner disposes of timber held for more than six months before such disposal, under any form or type of contract whereby he retains an economic interest in such timber, the disposal shall be considered to be a sale of such timber. The difference between the amounts realized from disposal of such timber in any taxable year and the adjusted basis for depletion thereof shall be considered to be a gain or loss upon the sale of such timber for such year. Such adjusted basis shall be computed in the same manner as provided in section 611 and the regulations thereunder with respect to the allowance for depletion. See paragraph (e) (2) of this section for definition of "owner". For the purpose of determining whether or not the timber disposed of was held for more than six months before such disposal the rules with respect to the holding period of property contained in section 1223 shall be applicable.

(2) In the case of such a disposal, the provisions of section 1231 apply and such timber shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231 (b), regardless of whether such timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the timber which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than six months will depend upon the application of section 1231 to the taxpayer for the taxable year.

(b) *Determination of date of disposal.* (1) For purposes of section 631 (b) and this section, the date of disposal of timber shall be deemed to be the date such timber is cut. However, if payment is made to the owner under the contract for timber before such timber is cut the owner may elect to treat the date of payment as the date of disposal of such timber. Such election shall be effective only for purposes of determining the holding period of such timber. Neither section 631 (b) nor the election thereunder has any effect on the time of reporting gain or loss. See subchapter E, chapter 1 of the Code and the regulations thereunder. See paragraph (c) (2) of this section for the effect of exercising the election with respect to the payment for timber held for six months or less. See paragraph (d) of this section for the treatment of payments received in advance of cutting.

(2) For purposes of section 631 (b) and this section, the "date such timber is cut" means the date when in the ordinary course of business the quantity of timber felled is first definitely determined.

(c) *Manner and effect of election to treat date of payment as the date of disposal.* (1) The election to treat the date of payment as the date of disposal of timber shall be evidenced by a statement attached to the taxpayer's income tax return filed on or before the due date (including extensions thereof) for the taxable year in which the payment is received. The statement shall specify the advance payments which are subject to the election and shall identify the contract under which the payments are made. However, in no case shall the time for making the election under section 631 (b) expire before the close of March 21, 1958.

(2) Where the election to treat the date of payment as the date of disposal is made with respect to a payment made in advance of cutting, and such payment is made six months or less from the date the timber disposed of was acquired, section 631 (b) shall not apply to such payment, irrespective of the date such timber is cut, since the timber was not held for more than six months prior to disposal.

(d) *Payments received in advance of cutting.* (1) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to cutting (such as advance royalty payments or minimum royalty payments) shall be treated under section 631 (b) as realized from the sale of timber if the contract of disposal provides that such amounts are to be applied as payment for timber subsequently cut. Such amounts will be so treated irrespective of whether or not an election has been made under paragraph (c) of this section to treat the date of payment as the date of disposal. For example, if no election has been made under paragraph (c) of this section, amounts received or accrued prior to cutting will be treated as realized from the sale of timber, provided the timber paid for is cut more than six months after the date of acquisition of such timber.

(2) However, if the right to cut timber under the contract expires, terminates, or is abandoned before the timber which has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and not as received from the sale of timber under section 631 (b). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received or accrued. The recomputation shall be made in the form of an amended return where necessary.

(3) (i) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631 (b) as amounts realized from the sale of timber to the extent attributable to timber held for more than six months.

(ii) The adjusted depletion basis attributable to the bonus shall be determined under the provisions of section 612 and the regulations thereunder. This subdivision may be illustrated as follows:

Example. Taxpayer A has held timber having a depletion basis of $90,000 for two months when he enters into a contract of disposal with B. B pays A a bonus of $5,000 upon the execution of the contract and agrees to pay X dollars per unit of timber to A as the timber is cut. A does not exercise the election to treat the date of payment as the date of disposal. It is estimated that there are 50,000 units of timber subject to the contract and that the total estimated royalties to be paid to A will be $95,000. A must report the bonus in the taxable year it is received or accrued by him. The portion of the basis of the timber attributable to the bonus is determined by the following formula:

$$\frac{\text{Bonus}}{\text{Bonus} + \text{amount of expected royalties}} \times \text{Basis of timber} = \text{Basis attributable to bonus}$$

$$\frac{\$5{,}000}{\$100{,}000} \times \$90{,}000 = \$4{,}500$$

(iii) To the extent attributable to timber not held for more than six months, such bonuses shall be treated as ordinary income subject to depletion. In order to determine the amount of the bonus allocable to timber not held for more than six months, the bonus shall be apportioned ratably over the estimated number of units of timber covered by the contract of disposal. This subdivision may be illustrated as follows:

Example. Assume under the facts stated in the example in subdivision (ii) of this subparagraph that B cuts 10,000 units of timber that have been held by A for six months or less. The amount of the bonus (as well as the royalties) attributable to these units must be reported as ordinary income subject to depletion. The amount of the bonus attributable to these units is determined by the following formula:

$$\frac{\text{Number of units cut held for six months or less}}{\text{Total units covered by the contract}} \times \text{Amount of bonus} = \text{Amount of bonus treated as ordinary income subject to depletion.}$$

$$\frac{10{,}000}{50{,}000} \times \$5{,}000 = \$1{,}000$$

The amount of the depletion attributable to the portion of the bonus received for timber held for six months or less is determined by the following formula:

$$\frac{\text{Amount of bonus attributable to timber held for six months or less}}{\text{Total bonus}} \times \text{Adjusted basis for depletion of bonus} = \text{Depletion allowance on timber held for six months or less.}$$

$$\frac{\$1{,}000}{\$5{,}000} \times \$4{,}500 = \$900$$

The amount of the bonus attributable to timber held for more than six months, and which is treated under section 631 (b) as realized from the sale of timber would be $4,000. The gain on such amount is $400 ($4,000—$3,600).

(iv) If the right to cut timber under the contract of disposal expires, terminates, or is abandoned before any timber is cut, the taxpayer shall treat the bonus received under such contract as ordinary income, not subject to depletion. Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such bonus was received. The recomputation shall be made in the form of an amended return where necessary.

(e) *Other rules for application of section.* (1) Amounts paid by the lessee for timber or the acquisition of timber cutting rights, whether designated as such or as a rental, royalty, or bonus, shall be treated as the cost of timber and constitute part of the lessee's depletable basis of the timber, irrespective of the treatment accorded such payments in the hands of the lessor.

(2) The provisions of section 631 (b) apply only to an owner of timber. An owner of timber means any person who owns an interest in timber, including a sublessor and a holder of a contract to cut timber. Such owner of timber must have a right to cut timber for sale on his own account or for use in his trade or business in order to own an interest in timber within the meaning of section 631 (b).

(3) For purposes of section 631 (b) and this section, the term "timber" includes evergreen trees which are more than 6 years old at the time severed from their roots and are sold for ornamental purposes such as Christmas decorations. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631 (b). The term "evergreen trees" is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

§ 1.631–3 Gain or loss upon the disposal of coal with a retained economic interest.

(a) *In general.* (1) The provisions of section 631(c) apply to an owner who disposes of coal (including lignite) held for more than 6 months before such disposal under any form or type of contract whereby he retains an economic interest in such coal. The difference between the amount realized from disposal of such coal in any taxable year, and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272, shall be gain or loss upon the sale of such coal. See paragraph (b)(4) of this section for definition of "owner".

(2) In the case of such a disposal, the provisions of section 1231 apply and such coal shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231 (b), regardless of whether such coal is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the coal which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than six months will depend upon the application of section 1231 to the taxpayer for the taxable year.

(b) *Rules for application of section.* (1) For purposes of section 631 (c) and this section, the date of disposal of such coal shall be deemed to be the date the coal is mined. If the coal has been held for more than 6 months on the date it is mined, it is immaterial that it had not been held for more than 6 months on the date of the contract. There shall be no allowance for percentage depletion provided in section 613 with respect to amounts which are considered to be realized from the sale of coal under section 631 (c).

(2) The term "adjusted depletion basis" as used in section 631 (c) and in this section means the basis for allowance of cost depletion provided in section 612 and the regulations thereunder. Such "adjusted depletion basis" shall include exploration or development expenditures treated as deferred expenses under section 615 (b) or 616 (b), or corresponding provisions of prior income tax laws, and be reduced by adjustments under section 1016 (a) (9) and (10), or corresponding provisions of prior income tax laws, relating to deductions of deferred expenses for exploration or development expenditures in the taxable year or any prior taxable years. The depletion unit of the coal disposed of shall be determined under the rules provided in the regulations under section 611 relating to cost depletion.

(3) (i) In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties (except rents and royalties paid by a lessee with respect to coal disposed of by the lessee as an "owner" under section 631 (c)) shall be determined without regard to the provisions of section 631 (c). Thus, the amounts of rents and royalties paid or incurred by a lessee with respect to coal shall be excluded from the lessee's gross income from the property for the purpose of determining his percentage depletion without regard to the treatment of such rents or royalties in the hands of the recipient under this section. See section 613 and the regulations thereunder.

(ii) However, a lessee who is also a sublessor may dispose of coal as an "owner" under section 631 (c). Rents and royalties paid with respect to coal disposed of by such a lessee under section 631 (c) shall increase the adjusted depletion basis of the coal and are not otherwise deductible. For example, B is a sublessor of a coal lease; A is the lessor; and C is the sublessee. B pays A a royalty of 50 cents per ton. C pays B a royalty of 60 cents per ton. The amount realized by B under section 631 (c) is 60 cents per ton and will be reduced by the adjusted depletion basis of 50 cents per ton, leaving a gain of 10 cents per ton taxable under section 631 (c).

(4) (i) The provisions of this section apply only to an owner who has disposed of coal and retained an economic interest. For the purposes of section 631 (c) and this section, the word "owner" means any person who owns an economic interest in coal in place, including a sublessor thereof. A person who merely acquires an economic interest and has not disposed of coal under a contract retaining an economic interest does not qualify under section 631 (c). A successor to the interest of a person who has disposed of coal under a contract by virtue of which he retained an economic interest in such coal is also entitled to the benefits of this section. Such sections shall not apply with respect to any income realized by any owner as co-adventurer, partner, or principal in the mining of such coal.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A owns a tract of coal land in fee. A leases to B the right to mine all the

coal in such tract in return for a royalty of 30 cents per ton. B subleases his right to mine coal in such tract to C, who agrees to pay A 30 cents per ton and to pay to B an additional royalty of 10 cents per ton. Section 631 (c) applies to the royalties of both A and B, if the other requisites of such section have been met.

Example (2). Assume the same facts as in example (1), except that D dies leaving his royalty interest to D. D has an economic interest in the coal in place and qualifies for section 631 (c) treatment with respect to his share of the royalties since he is a successor in title to A.

Example (3). Assume the same facts as in example (1), except that E agrees to pay a sum of money to C in return for 10 cents per ton on the coal mined by C. E has an economic interest since he must look solely to the extraction of the coal for the return of his investment. However, E has not made a disposal of coal under a contract wherein he retains an economic interest, and, therefore, does not qualify under section 631 (c). E is entitled to depletion on his royalties.

(c) *Payments received in advance of mining.* (1) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to mining shall be treated under section 631 (c) as received from the sale of coal if the contract of disposal provides that such amounts are to be applied as payment for coal subsequently mined. For example, advance royalty payments or minimum royalty payments received by an owner of coal qualify under such section where the contract of disposal grants the lessee the right to apply such royalties in payment of coal mined at a later time. Thus, if A acquires coal rights on January 1, and on January 30 enters into a contract of disposal providing that mining shall begin July 2, and mining actually begins no earlier, any advance payments which A receives qualify under section 631 (c).

(2) However, if the right to mine coal under the contract expires, terminates, or is abandoned before the coal which has been paid for is mined, the taxpayer shall treat payments attributable to the unmined coal as ordinary income and not as received from the sale of coal under section 631 (c). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received. The recomputation shall be made in the form of an amended return where necessary.

(3) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631 (c) as received from the sale of coal to the extent attributable to coal held for more than six months. The rules contained in paragraph (d) of § 1.631–2 relating to bonuses in the case of contracts for the disposal of timber shall be equally applicable in the case of bonuses received for the grant of a contract of disposal of coal under this section.

(d) *Non-application of section.* Section 631 (c) shall not affect the application of the provisions of subchapter G, chapter 1 of the Code, relating to corporations used to avoid income tax on shareholders. For example, in applying the provisions of section 543(a)(8)(A), the amounts received from a disposal of coal subject to section 631(c) shall be considered as mineral royalties. For purposes of determining whether certain deductions of the taxpayer constitute 15 percent or more of gross income under section 543(a)(8)(B), the deductions disallowed under section 272 shall be considered as allowable.

§ 1.632 Statutory provisions; sale of oil or gas properties.

SEC. 632. *Sale of oil or gas properties.* In the case of a bona fide sale of any oil or gas property, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the taxpayer, the portion of the surtax imposed by section 1 attributable to such sale shall not exceed 30 percent of the selling price of such property or interest.

§ 1.632–1 Surtax on sale of oil or gas properties.

(a) If the taxpayer, by prospecting and locating claims or by exploring or discovering undeveloped claims, has demonstrated the principal value of oil or gas property, which prior to his efforts had a relatively minor value, the portion of the surtax imposed by section 1 (see section 1(c)) attributable to a sale of such property, or of any interest of the taxpayer therein, shall not exceed 30 percent of the selling price of such property or such interest. Shares of stock in a corporation owning oil or gas property do not constitute an interest in such property. To determine the application of section 632 to a particular case, the taxpayer should first compute the surtax imposed by section 1 upon his entire taxable income, including the taxable income from any sale of such property or interest therein, without regard to section 632. The proportion of the surtax, so computed, indicated by the ratio which the taxpayer's taxable income from the sale of the property or interest therein, computed as prescribed in this section, bears to his total taxable income is the portion of the surtax attributable to such sale and, if it exceeds 30 percent of the selling price of such property or interest, such portion of the surtax shall be reduced to that amount.

(b) In determining the portion of the taxable income attributable to the sale of such oil or gas property or interest therein, the taxpayer shall allocate to the gross income derived from such sale, and to the gross income derived from all other sources, the expenses, losses, and other deductions properly appertaining thereto and shall apply any general expenses, losses, and deductions (which cannot properly be otherwise allocated) ratably to the gross income from all sources. The gross income derived from the sale of such oil or gas property or interest therein, less the deductions properly appertaining thereto and less its proportion of any general deductions, shall be the taxable income attributable to such sale. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or apportioned.

ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS

ESTATES, TRUSTS, AND BENEFICIARIES

GENERAL RULES FOR TAXATION OF ESTATES AND TRUSTS

§ 1.641(a) Statutory provisions; estates and trusts; imposition of tax; application of tax.

SEC. 641. *Imposition of tax*—(a) *Application of tax.* The taxes imposed by this chapter on individuals shall apply to the taxable income of estates or of any kind of property held in trust, including—

(1) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust;

(2) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(3) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

(4) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

§ 1.641(a)–0 Scope of subchapter J.

(a) *In general.* Subchapter J (section 641 and following), chapter 1 of the Code, deals with the taxation of income of estates and trusts and their beneficiaries, and of income in respect of decedents. Part I of subchapter J contains general rules for taxation of estates and trusts (subpart A), specific rules relating to trusts which distribute current income only (subpart B), estates and trusts which may accumulate income or which distribute corpus (subpart C), treatment of excess distributions by trusts (subpart D), grantors and other persons treated as substantial owners (subpart E), and miscellaneous provisions relating to limitations on charitable deductions, income of an estate or trust in case of divorce, and taxable years to which the provisions of subchapter J are applicable (subpart F). Part II of subchapter J relates to the treatment of income in respect of decedents. However, the provisions of subchapter J do not apply to employees' trusts subject to subchapters D and F, chapter 1 of the Code, and common trust funds subject to subchapter H, chapter 1 of the Code.

(b) *Scope of subparts A, B, C, and D.* Subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Code, relate to the taxation of estates and trusts and their beneficiaries. These subparts have no application to any portion of the corpus or income of a trust which is to be regarded, within the meaning of the Code, as that of the grantor or others treated as its substantial owners. See subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, and the regulations thereunder for rules for the treatment of any portion of a trust where the grantor (or another person) is treated as the substantial owner. So-called alimony trusts are treated under subparts A, B, C, and D, except to the extent otherwise provided in section 71 or section 682. These subparts have no application to bene-

ficiaries of nonexempt employees' trusts. See section 402(b) and the regulations thereunder.

§ 1.641(a)–1 Imposition of tax; application of tax.

Section 641 prescribes that the taxes imposed upon individuals by chapter 1 of the Code apply to the income of estates or of any kind of property held in trust. The rates of tax, the statutory provisions respecting gross income, and, with certain exceptions, the deductions and credits allowed to individuals apply also to estates and trusts.

§ 1.641(a)–2 Gross income of estates and trusts.

The gross income of an estate or trust is determined in the same manner as that of an individual. Thus, the gross income of an estate or trust consists of all items of gross income received during the taxable year, including:

(a) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(b) Income accumulated or held for future distribution under the terms of the will or trust;

(c) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(d) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

(e) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

The several classes of income enumerated in this section do not exclude others which also may come within the general purposes of section 641.

§ 1.641(b) Statutory provisions; estates and trusts; computation and payment of tax.

SEC. 641. *Imposition of tax.* * * *

(b) *Computation and payment.* The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part. The tax shall be computed on such taxable income and shall be paid by the fiduciary.

§ 1.641(b)–1 Computation and payment of tax; deductions and credits of estates and trusts.

Generally, the deductions and credits allowed to individuals are also allowed to estates and trusts. However, there are special rules for the computation of certain deductions and for the allocation between the estate or trust and the beneficiaries of certain credits and deductions. See section 642 and the regulations thereunder. In addition, an estate or trust is allowed to deduct, in computing its taxable income, the deductions provided by sections 651 and 661 and regulations thereunder, relating to distributions to beneficiaries.

§ 1.641(b)–2 Filing of returns and payment of the tax.

(a) The fiduciary is required to make and file the return and pay the tax on the taxable income of an estate or of a trust. Liability for the payment of the tax on the taxable income of an estate attaches to the person of the executor or administrator up to and after his discharge if, prior to distribution and discharge, he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed. For the extent of such liability, see section 3467 of the Revised Statutes, as amended by section 518 of the Revenue Act of 1934 (31 U. S. C. 192). Liability for the tax also follows the assets of the estate distributed to heirs, devisees, legatees, and distributees, who may be required to discharge the amount of the tax due and unpaid to the extent of the distributive shares received by them. See section 6901. The same considerations apply to trusts.

(b) The estate of an infant, incompetent, or other person under a disability, or, in general, of an individual or corporation in receivership or bankruptcy is not a taxable entity separate from the person for whom the fiduciary is acting, in that respect differing from the estate of a deceased person or of a trust. See section 6012 (b) (2) and (3) for provisions relating to the obligation of the fiduciary with respect to returns of such persons.

§ 1.641(b)–3 Termination of estates and trusts.

(a) The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. For example, where an executor who is also named as trustee under a will fails to obtain his discharge as executor, the period of administration continues only until the duties of administration are complete and he actually assumes his duties as trustee, whether or not pursuant to a court order. However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).

(b) Generally, the determination of whether a trust has terminated depends upon whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than upon the technicality of whether or not the trustee has rendered his final accounting. A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. Thus, if under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the affairs of the trust. However, the winding up of a trust cannot be unduly postponed and if the distribution of the trust corpus is unreasonably delayed, the trust is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the trustee to complete the administration of the trust. Further, a trust will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).

(c) (1) Except as provided in subparagraph (2) of this paragraph, during the period between the occurrence of an event which causes a trust to terminate and the time when the trust is considered as terminated under this section, whether or not the income and the excess of capital gains over capital losses of the trust are to be considered as amounts required to be distributed currently to the ultimate distributee for the year in which they are received depends upon the principles stated in § 1.651(a)–2. See § 1.663 et seq. for application of the separate share rule.

(2) (i) Except in cases to which the last sentence of this subdivision applies, for taxable years of a trust ending before September 1, 1957, subparagraph (1) of this paragraph shall not apply and the rule of subdivision (ii) of this subparagraph shall apply unless the trustee elects to have subparagraph (1) of this paragraph apply. Such election shall be made by the trustee in a statement filed on or before April 15, 1959, with the district director with whom such trust's return for any such taxable year was filed. The election provided by this subdivision shall not be available if the treatment given the income and the excess of capital gains over capital losses for taxable years for which returns have been filed was consistent with the provisions of subparagraph (1) of this paragraph.

(ii) The rule referred to in subdivision (i) of this subparagraph is as follows: During the period between the occurrence of an event which causes a trust to terminate and the time when a trust is considered as terminated under this section, the income and the excess of capital gains over capital losses of the trust are in general considered as

amounts required to be distributed for the year in which they are received. For example, a trust instrument provides for the payment of income to A during her life, and upon her death for the payment of the corpus to B. The trust reports on the basis of the calendar year. A dies on November 1, 1955, but no distribution is made to B until January 15, 1956. The income of the trust and the excess of capital gains over capital losses for the entire year 1955, to the extent not paid, credited, or required to be distributed to A or A's estate, are treated under sections 661 and 662 as amounts required to be distributed to B for the year 1955.

(d) If a trust or the administration or settlement of an estate is considered terminated under this section for Federal income tax purposes (as for instance, because administration has been unduly prolonged), the gross income, deductions, and credits of the estate or trust are, subsequent to the termination, considered the gross income, deductions, and credits of the person or persons succeeding to the property of the estate or trust.

§ 1.642(a)(1) Statutory provisions; estates and trusts; special rules for credits and deductions; partially tax-exempt interest.

SEC. 642. *Special rules for credits and deductions*—(a) *Credits against tax*—(1) *Partially tax-exempt interest.* An estate or trust shall be allowed the credit against tax for partially tax-exempt interest provided by section 35 only in respect of so much of such interest as is not properly allocable to any beneficiary under section 652 or 662. If the estate or trust elects under section 171 to treat as amortizable the premium on bonds with respect to the interest on which the credit is allowable under section 35, such credit (whether allowable to the estate or trust or to the beneficiary) shall be reduced under section 171 (a) (3).

§ 1.642(a)(1)–1 Partially tax-exempt interest.

An estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit does not relate to interest properly allocable to a beneficiary under section 652 or 662 and the regulations thereunder. A beneficiary of an estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit relates to interest properly allocable to him under section 652 or 662 and the regulations thereunder. If an estate or trust holds partially tax-exempt bonds and elects under section 171 to treat the premium on the bonds as amortizable, the credit allowable under section 35, with respect to the bond interest (whether allowable to the estate or trust or to the beneficiary), is reduced under section 171(a)(3) by reducing the shares of the interest allocable, respectively, to the estate or trust and its beneficiary by the portion of the amortization deduction attributable to the shares.

§ 1.642(a)(2) Statutory provisions; estates and trusts; special rules for credits and deductions; foreign taxes.

SEC. 642. *Special rules for credits and deductions*—(a) *Credits against tax.* * * *

(2) *Foreign taxes.* An estate or trust shall be allowed the credit against tax for taxes imposed by foreign countries and possessions of the United States, to the extent allowed by section 901, only in respect of so much of the taxes described in such section as is not properly allocable under such section to the beneficiaries.

§ 1.642(a)(2)–1 Foreign taxes.

An estate or trust is allowed the credit against tax for taxes imposed by foreign countries and possessions of the United States to the extent allowed by section 901 only for so much of those taxes as are not properly allocable under that section to the beneficiaries. See section 901 (b) (4). For purposes of section 901 (b) (4), the term "beneficiaries" includes charitable beneficiaries.

§ 1.642(a)(3) Statutory provisions; estates and trusts; special rules for credits and deductions; dividends.

SEC. 642. *Special rules for credits and deductions*—(a) *Credits against tax.* * * *

(3) *Dividends received by individuals.* An estate or trust shall be allowed the credit against tax for dividends received provided by section 34 only in respect of so much of such dividends as is not properly allocable to any beneficiary under section 652 or 662. For purposes of determining the time of receipt of dividends under section 34 and section 116, the amount of dividends properly allocable to a beneficiary under section 652 or 662 shall be deemed to have been received by the beneficiary ratably on the same dates that the dividends were received by the estate or trust.

§ 1.642(a)(3)–1 Dividends received by an estate or trust.

An estate or trust is allowed a credit against tax for dividends received (see section 34) only for so much of the dividends as are not properly allocable to any beneficiary under section 652 or 662. For treatment of the credit in the hands of the beneficiary see § 1.652(b)–1.

§ 1.642(a)(3)–2 Time of receipt of dividends by beneficiary.

In general, dividends are deemed received by a beneficiary in the taxable year in which they are includible in his gross income under section 652 or 662. For example, a simple trust, reporting on the basis of a fiscal year ending October 30, receives quarterly dividends on November 3, 1954, and February 3, May 3, and August 3, 1955. These dividends are all allocable to beneficiary A, reporting on a calendar year basis, under section 652 and are deemed received by A in 1955. See section 652 (c). Accordingly, A may take all these dividends into account in determining his credit for dividends received under section 34, and his dividends exclusion under section 116. However, solely for purposes of determining whether dividends deemed received by individuals from trusts or estates qualify under the time limitations of section 34 (a) or section 116 (a), section 642 (a) (3) provides that the time of receipt of the dividends by the trust or estate is also considered the time of receipt by the beneficiary. For example, a simple trust reporting on the basis of a fiscal year ending October 30 receives quarterly dividends on December 3, 1953, and March 3, June 3, and September 3, 1954. These dividends are all allocable to beneficiary A, reporting on the calendar year basis, under section 652 and are includible in his income for 1954. However, for purposes of section 34 (a) or section 116 (a), these dividends are deemed received by A on the same dates that the trust received them. Accordingly, A may take into account in determining the credit under section 34 only those dividends received by the trust on September 3, 1954, since the dividend received credit is not allowed under section 34 for dividends received before August 1, 1954.

§ 1.642(a)(3)–3 Cross reference.

See § 1.683–2(c) for examples relating to the treatment of dividends received by an estate or trust during a fiscal year beginning in 1953 and ending in 1954.

§ 1.642(b) Statutory provisions; estates and trusts; special rules for credits and deductions; personal exemption.

SEC. 642. *Special rules for credits and deductions.* * * *

(b) *Deduction for personal exemption.* An estate shall be allowed a deduction of $600. A trust which, under its governing instrument, is required to distribute all of its income currently shall be allowed a deduction of $300. All other trusts shall be allowed a deduction of $100. The deductions allowed by this subsection shall be in lieu of the deductions allowed under section 151 (relating to deduction for personal exemption).

§ 1.642(b)–1 Deduction for personal exemption.

In lieu of the deduction for personal exemptions provided by section 151:

(a) An estate is allowed a deduction of $600,

(b) A trust which, under its governing instrument, is required to distribute currently all of its income for the taxable year is allowed a deduction of $300, and

(c) All other trusts are allowed a deduction of $100.

A trust which, under its governing instrument, is required to distribute all of its income currently is allowed a deduction of $300, even though it also distributes amounts other than income in the taxable year and even though it may be required to make distributions which would qualify for the charitable contributions deduction under section 642 (c) (and therefore does not qualify as a "simple trust" under sections 651–652). A trust for the payment of an annuity is allowed a deduction of $300 in a taxable year in which the amount of the annuity required to be paid equals or exceeds all the income of the trust for the taxable year. For the meaning of the term "income required to be distributed currently", see § 1.651 (a)–2.

§ 1.642(c) Statutory provisions; estates and trusts; special rules for credits and deductions; charitable contributions deduction.

SEC. 642. *Special rules for credits and deductions.* * * *

(c) *Deduction for amounts paid or permanently set aside for a charitable purpose.* In the case of an estate or trust (other than a trust meeting the specifications of subpart B) there shall be allowed as a deduction in computing its taxable income (in lieu of the deductions allowed by section 170 (a), relating to deduction for charitable, etc., con-

section 652 or 662 and the regulations

tributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid or permanently set aside for a purpose specified in section 170 (c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit. For this purpose, to the extent that such amount consists of gain from the sale or exchange of capital assets held for more than 6 months, proper adjustment of the deduction otherwise allowable under this subsection shall be made for any deduction allowable to the estate or trust under section 1202 (relating to deduction for excess of capital gains over capital losses). In the case of a trust, the deduction allowed by this subsection shall be subject to section 681 (relating to unrelated business income and prohibited transactions).

§ 1.642(c)–1 Charitable contributions deduction.

Any part of the gross income of an estate or trust which, by the terms of the will or of the instrument creating the trust:

(a) Is, during the taxable year, paid or permanently set aside for a purpose specified in section 170 (c), relating to charitable contributions, or

(b) Is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit,

is allowed as a deduction to the estate or trust in lieu of the deduction authorized by section 170 (a). For this purpose, an amount received by an estate or trust which is includible in its gross income as income in respect of a decedent under section 691 (a) (1) is deemed "gross income" of the estate or trust. In the case of a trust, the deduction otherwise allowable under section 642 (c) and this section is subject to the limitations of section 681 (relating to unrelated business income and prohibited transactions). See section 681 and the regulations thereunder.

§ 1.642(c)–2 Reduction of charitable contributions deduction by exempt income.

If an estate or trust pays, permanently sets aside, or uses any amount of its income for the purposes specified in section 642 (c) and that amount includes any items of estate or trust income not entering into the gross income of the estate or trust, the deduction under this section is limited to the gross income so paid, permanently set aside, or used. In determining whether such amounts include particular items of income of an estate or trust, if the governing instrument specifically provides as to the source out of which amounts shall be paid, permanently set aside, or used for such purposes, the specific provision controls. In the absence of specific provisions in the governing instrument, an amount to which section 642 (c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See paragraph (b) of § 1.643 (a)–5 for the method of determining the allocable portion of exempt income and foreign income. For the purpose of this section, the provisions of section 116 (relating to exclusion of dividends) are not taken into account. For examples showing the determination of the character of an amount deductible under section 642 (c), see examples (1) and (2) of § 1.662 (b)–2 and paragraph (e) of § 1.662 (c)–4.

§ 1.642(c)–3 Capital gains included in charitable contribution.

Where any amount of the income paid, permanently set aside, or used for the purposes specified in section 642(c) is attributable to gain from the sale or exchange of capital assets held for more than six months, the amount of the deduction allowable under section 642(c) must be adjusted for any deduction provided in section 1202 of 50 percent of the excess, if any, of the net long-term capital gain over the net short-term capital loss. For determination of the extent to which the charitable, etc., contribution referred to in section 642(c) is deemed to consist of long-term capital gains, see § 1.642(c)–2. For example: Under the terms of the trust instrument, the income of the trust is currently distributable to A during his life and capital gains are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of A. Upon A's death the corpus of the trust is to be distributed to M University, an organization described in section 501 (c) (3) which is exempt from taxation under section 501 (a). During the taxable year 1954, the trust has long-term capital gains of $100,000 which, although allocable to corpus, are permanently set aside for charitable purposes. The trust includes $100,000 in gross income but is allowed a deduction of $50,000 under section 1202 for the long-term capital gains and a charitable contributions deduction of $50,000 under section 642 (c) ($100,000 permanently set aside for charitable purposes less $50,000 allowed as a deduction under section 1202 with respect to such $100,000).

§ 1.642(c)–4 Cross reference.

For rules applicable to the annual information return that must be filed by certain trusts claiming charitable, etc., deductions under section 642(c) for the taxable year, see section 6034 and the regulations thereunder.

§ 1.642(d) Statutory provisions; estates and trusts; special rules for credits and deductions; net operating loss deduction.

SEC. 642. *Special rules for credits and deductions.* * * *

(d) *Net operating loss deduction.* The benefit of the deduction for net operating losses provided by section 172 shall be allowed to estates and trusts under regulations prescribed by the Secretary or his delegate.

§ 1.642(d)–1 Net operating loss deduction.

The net operating loss deduction allowed by section 172 is available to estates and trusts generally, with the following exceptions and limitations:

(a) In computing gross income and deductions for the purposes of section 172, a trust shall exclude that portion of the income and deductions attributable to the grantor or another person under sections 671 through 678 (relating to grantors and others treated as substantial owners).

(b) An estate or trust shall not, for the purposes of section 172, avail itself of the deductions allowed by section 642 (c) (relating to charitable contributions deductions) and sections 651 and 661 (relating to deductions for distributions).

§ 1.642(e) Statutory provisions; estates and trusts; special rules for credits and deductions; deduction for depreciation and depletion.

SEC. 642. *Special rules for credits and deductions.* * * *

(e) *Deduction for depreciation and depletion.* An estate or trust shall be allowed the deduction for depreciation and depletion only to the extent not allowable to beneficiaries under sections 167 (g) and 611 (b).

§ 1.642(e)–1 Depreciation and depletion.

An estate or trust is allowed the deductions for depreciation and depletion, but only to the extent the deductions are not apportioned to beneficiaries under sections 167 (g) and 611 (b). For purposes of sections 167 (g) and 611 (b), the term "beneficiaries" includes charitable beneficiaries. See the regulations under those sections.

§ 1.642(f) Statutory provisions; estates and trusts; special rules for credits and deductions; amortization of emergency or grain storage facilities.

SEC. 642. *Special rules for credits and deductions.* * * *

(f) *Amortization of emergency or grain storage facilities.* The benefit of the deductions for amortization of emergency and grain storage facilities provided by sections 168 and 169 shall be allowed to estates and trusts in the same manner as in the case of an individual. The allowable deduction shall be apportioned between the income beneficiaries and the fiduciary under regulations prescribed by the Secretary or his delegate.

§ 1.642(f)–1 Amortization of emergency or grain storage facilities.

An estate or trust is allowed amortization deductions with respect to an emergency facility as defined in section 168 (d) and with respect to a grain storage facility as defined in section 169(d) in the same manner and to the same extent as in the case of an individual. However, the principles governing the apportionment of the deductions for depreciation and depletion between the fiduciaries and the beneficiaries of an estate or trust (see sections 167(g) and 611(b) and the regulations thereunder) shall be applicable with respect to such amortization deductions.

§ 1.642(g) Statutory provisions; estates and trusts; special rules for credits and deductions; disallowance of double deductions.

SEC. 642. *Special rules for credits and deductions.* * * *

(g) *Disallowance of double deductions.* Amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be al-

lowed as a deduction in computing the taxable income of the estate, unless there is filed, within the time and in the manner and form prescribed by the Secretary or his delegate, a statement that the amounts have not been allowed as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054. This subsection shall not apply with respect to deductions allowed under part II (relating to income in respect of decedents).

§ 1.642(g)–1 Disallowance of double deductions; in general.

Amounts allowable under section 2053(a)(2) (relating to administration expenses) or under section 2054 (relating to losses during administration) as deductions in computing the taxable estate of a decedent are not allowed as deductions in computing the taxable income of the estate unless there is filed a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under section 2053 or 2054 and that all rights to have such items allowed at any time as deductions under section 2053 or 2054 are waived. The statement should be filed with the return for the year for which the items are claimed as deductions or with the district director for the internal revenue district in which the return was filed, for association with the return. The statement may be filed at any time before the expiration of the statutory period of limitation applicable to the taxable year for which the deduction is sought. Allowance of a deduction in computing an estate's taxable income is not precluded by claiming a deduction in the estate tax return, so long as the estate tax deduction is not finally allowed and the statement is filed. However, after a statement is filed under section 642 (g) with respect to a particular item or portion of an item, the item cannot thereafter be allowed as a deduction for estate tax purposes since the waiver operates as a relinquishment of the right to have the deduction allowed at any time under section 2053 or 2054.

§ 1.642(g)–2 Deductions included.

It is not required that the total deductions, or the total amount of any deduction, to which section 642(g) is applicable be treated in the same way. One deduction or portion of a deduction may be allowed for income tax purposes if the appropriate statement is filed, while another deduction or portion is allowed for estate tax purposes. Section 642(g) has no application to deductions for taxes, interest, business expenses, and other items accrued at the date of a decedent's death so that they are allowable as a deduction under section 2053 (a)(3) for estate tax purposes as claims against the estate, and are also allowable under section 691(b) as deductions in respect of a decedent for income tax purposes. However, section 642(g) is applicable to deductions for interest, business expenses, and other items not accrued at the date of the decedent's death so that they are allowable as deductions for estate tax purposes only as administration expenses under section 2053(a)(2). Although deductible under section 2053(a)(3) in determining the value of the taxable estate of a decedent, medical, dental, etc., expenses of a decedent which are paid by the estate of the decedent are not deductible in computing the taxable income of the estate. See section 213 (d) and the regulations thereunder for rules relating to the deductibility of such expenses in computing the taxable income of the decedent.

§ 1.642(h) Statutory provisions; estates and trusts; special rules for credits and deductions; unused loss carryovers and excess deductions.

SEC. 642. *Special rules for credits and deductions.* * * *

(h) *Unused loss carryovers and excess deductions on termination available to beneficiaries.* If on the termination of an estate or trust, the estate or trust has—

(1) A net operating loss carryover under section 172 or a capital loss carryover under section 1212, or

(2) For the last taxable year of the estate or trust deductions (other than the deductions allowed under subsections (b) or (c)) in excess of gross income for such year,

then such carryover or such excess shall be allowed as a deduction, in accordance with regulations prescribed by the Secretary or his delegate, to the beneficiaries succeeding to the property of the estate or trust.

§ 1.642(h)–1 Unused loss carryovers on termination of an estate or trust.

(a) If, on the final termination of an estate or trust, a net operating loss carryover under section 172 or a capital loss carryover under section 1212 would be allowable to the estate or trust in a taxable year subsequent to the taxable year of termination but for the termination, the carryover or carryovers are allowed under section 642 (h) (1) to the beneficiaries succeeding to the property of the estate or trust. See § 1.641 (b)–3 for the determination of when an estate or trust terminates.

(b) The net operating loss carryover and the capital loss carryover are the same in the hands of a beneficiary as in the estate or trust and are taken into account in computing both taxable income and adjusted gross income. The first taxable year of the beneficiary to which the loss shall be carried over is the taxable year of the beneficiary in which or with which the estate or trust terminates. However, the last taxable year of the estate or trust (whether or not a short taxable year) and the first taxable year of the beneficiary to which a loss is carried over each constitute a taxable year for purposes of determining the number of years to which a loss may be carried over. For example: A trust distributes all of its assets to A, the sole remainderman, and terminates on December 31, 1954, when it has a capital loss carryover of $10,000 attributable to transactions during the taxable year 1952. A, who reports on the calendar year basis, otherwise has ordinary income of $10,000 and capital gains of $4,000 for the taxable year 1954. A would offset his capital gains of $4,000 against the capital loss of the trust and, in addition, deduct under section 1211 (b) $1,000 on his return for the taxable year 1954. The balance of the capital loss carryover of $5,000 may be carried over only to the years 1955 and 1956. For the treatment of the net operating loss carryover when the last taxable year of the estate or trust is the last taxable year to which such loss can be carried over, see § 1.642 (h)–2.

§ 1.642(h)–2 Excess deductions on termination of an estate or trust.

(a) If, on the termination of an estate or trust, the estate or trust has for its last taxable year deductions (other than the deductions allowed under section 642 (b) (relating to personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income, the excess is allowed under section 642(h)(2) as a deduction to the beneficiaries succeeding to the property of the estate or trust. The deduction is allowed only in computing taxable income; it is not allowed in computing adjusted gross income. The deduction is allowable only in the taxable year of the beneficiary in which or with which the estate or trust terminates, whether the year of termination of the estate or trust is of normal duration or is a short taxable year. For example: Assume that a trust distributes all of its assets to B and terminates on December 31, 1954. As of that date it had excess deductions, for example, because of corpus commissions on termination, of $18,000. B, who reported on the calendar year basis, could claim the $18,000 as a deduction for the taxable year 1954. However, if the deduction (when added to his other deductions) exceeds his gross income, the excess may not be carried over to the year 1955 or subsequent years.

(b) A deduction based upon a net operating loss carryover will never be allowed to beneficiaries under both paragraphs (1) and (2) of section 642 (h). Accordingly, a net operating loss deduction which is allowable to beneficiaries succeeding to the property of the estate or trust under the provisions of paragraph (1) of section 642 (h) cannot also be considered a deduction for purposes of paragraph (2) of section 642 (h) and paragraph (a) of this section. However, if the last taxable year of the estate or trust is the last year in which a deduction on account of a net operating loss may be taken, the deduction, to the extent not absorbed in that taxable year by the estate or trust, is considered an "excess deduction" under section 642 (h)(2) and paragraph (a) of this section.

(c) Any item of income or deduction, or any part thereof, which is taken into account in determining the net operating loss or capital loss carryover of the estate or trust for its last taxable year shall not be taken into account again in determining excess deductions on termination of the trust or estate within the meaning of section 642 (h) (2) and paragraph (a) of this section (see example in § 1.642 (h)–5).

§ 1.642(h)–3 Meaning of "beneficiaries succeeding to the property of the estate or trust".

(a) The phrase "beneficiaries succeeding to the property of the estate or trust" means those beneficiaries upon termination of the estate or trust who

lowed for income tax purposes if the

bear the burden of any loss for which a carryover is allowed, or of any excess of deductions over gross income for which a deduction is allowed, under section 642(h).

(b) With reference to an intestate estate, the phrase means the heirs and next of kin to whom the estate is distributed, or if the estate is insolvent, to whom it would have been distributed if it had not been insolvent. If a decedent's spouse is entitled to a specified dollar amount of property before any distribution to other heirs and next of kin, and if the estate is less than that amount, the spouse is the beneficiary succeeding to the property of the estate or trust to the extent of the deficiency in amount.

(c) In the case of a testate estate, the phrase normally means the residuary beneficiaries (including a residuary trust), and not specific legatees or devisees, pecuniary legatees, or other nonresiduary beneficiaries. However, the phrase does not include the recipient of a specific sum of money even though it is payable out of the residue, except to the extent that it is not payable in full. On the other hand, the phrase includes a beneficiary (including a trust) who is not strictly a residuary beneficiary but whose devise or bequest is determined by the value of the decedent's estate as reduced by the loss or deductions in question. Thus the phrase includes:

(1) A beneficiary of a fraction of a decedent's net estate after payment of debts, expenses, etc.;

(2) A nonresiduary legatee or devisee, to the extent of any deficiency in his legacy or devise resulting from the insufficiency of the estate to satisfy it in full;

(3) A surviving spouse receiving a fractional share of an estate in fee under a statutory right of election, to the extent that the loss or deductions are taken into account in determining the share. However, the phrase does not include a recipient of dower or curtesy, or any income beneficiary of the estate or trust from which the loss or excess deduction is carried over.

(d) The principles discussed in paragraph (c) of this section are equally applicable to trust beneficiaries. A remainderman who receives all or a fractional share of the property of a trust as a result of the final termination of the trust is a beneficiary succeeding to the property of the trust. For example, if property is transferred to pay the income to A for life and then to pay $10,000 to B and distribute the balance of the trust corpus to C, C and not B is considered to be the succeeding beneficiary except to the extent that the trust corpus is insufficient to pay B $10,000.

§ 1.642(h)–4 Allocation.

The carryovers and excess deductions to which section 642(h) applies are allocated among the beneficiaries succeeding to the property of an estate or trust (see § 1.642(h)–3) proportionately according to the share of each in the burden of the loss or deductions. A person who qualified as a beneficiary succeeding to the property of an estate or trust with respect to one amount and does not qualify with respect to another amount is a beneficiary succeeding to the property of the estate or trust as to the amount with respect to which he qualifies. The application of this section may be illustrated by the following example:

Example. A decedent's will leaves $100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only $90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of $5,000, and a capital loss carryover of $15,000, to both of which section 642 (h) applies. A is a beneficiary succeeding to the property of the estate to the extent of $10,000, and since the total of the excess of deductions and the loss carryover is $20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C.

§ 1.642(h)–5 Example.

The application of section 642(h) may be illustrated by the following example:

Example. (a) A decedent dies January 31, 1954, leaving a will which provides for distributing all her estate equally to A and an existing trust for B. The period of administration of the estate terminates on December 31, 1954, at which time all the property of the estate is distributed to A and the trust. A reports his income for tax purposes on a calendar year basis, and the trust reports its income on the basis of a fiscal year ending August 31. During the period of the administration, the estate has the following items of income and deductions:

Taxable interest	$2,500
Business income	3,000
Total	5,500
Business expenses (including administrative expense allocable to business income)	5,000
Administrative expenses and corpus commissions not allocable to business income	9,800
Total deductions	14,800

It also has a capital loss of $5,000.

(b) Under section 642 (h) (1), an unused net operating loss carryover of the estate on termination of $2,000 will be allowable to: A to the extent of $1,000 for his taxable year 1954 and the next four taxable years in accordance with section 172; and to the trust to the extent of $1,000 for its taxable year ending August 31, 1955, and its next four taxable years. The amount of the net operating loss carryover is computed as follows:

Deductions of estate for 1954	$14,800
Less adjustment under section 172 (d) (4) (deductions not attributable to a trade or business ($9,800) allowable only to extent of gross income not derived from such trade or business ($2,500))	7,300
Deductions as adjusted	7,500
Gross income of estate for 1954	5,500
Net operating loss of estate for 1954	2,000

(No deduction for capital loss of $5,000 under section 172 (d) (2).

Neither A nor the trust will be allowed to carry back any part of the net operating loss made available to them under section 642 (h) (1).

(c) Under section 642 (h) (2), excess deductions of the estate of $7,300 will be allowed as a deduction to A to the extent of $3,650 for the calendar year 1954 and to the trust to the extent of $3,650 for the taxable year ending August 31, 1955. The deduction of $7,300 for administrative expenses and corpus commissions is the only amount which was not taken into account in determining the net operating loss of the estate ($9,800 of such expenses less $2,500 taken into account).

(d) Under section 642 (h) (1), there will be allowable to A a capital loss carryover of $2,500 for his taxable year 1954 and for his next four taxable years in accordance with section 1212. There will be allowable to the trust a similar capital loss carryover of $2,500 for its taxable year ending August 31, 1955, and its next four taxable years (but see paragraph (b) of § 1.643 (a)–3).

(e) The carryovers and excess deductions are not allowable directly to B, the trust beneficiary, but to the extent the distributable net income of the trust is reduced by the carryovers and excess deductions B may receive indirect benefit.

§ 1.642(i) Statutory provisions; estates and trusts; special rules for credits and deductions; disallowance of standard deduction.

SEC. 642. *Special rules for credits and deductions.* * * *

(i) *Cross reference.* For disallowance of standard deduction in case of estates and trusts see section 142 (b) (4).

§ 1.642(i)–1 Disallowance of standard deduction (cross reference).

The standard deduction is not allowed to estates and trusts (see section 142(b) (4)).

§ 1.643(a) Statutory provisions; estates and trusts; definition of distributable net income.

SEC. 643. *Definitions applicable to subparts A, B, C, and D*—(a) *Distributable net income.* For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications—

(1) *Deduction for distributions.* No deduction shall be taken under sections 651 and 661 (relating to additional deductions).

(2) *Deduction for personal exemption.* No deduction shall be taken under section 642 (b) (relating to deduction for personal exemptions).

(3) *Capital gains and losses.* Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642 (c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) shall not be taken into account.

(4) *Extraordinary dividends and taxable stock dividends.* For purposes only of subpart B (relating to trusts which distribute current income only), there shall be excluded those items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus

under the terms of the governing instrument and applicable local law.

(5) *Tax-exempt interest.* There shall be included any tax-exempt interest to which section 103 applies, reduced by any amounts which would be deductible in respect of disbursements allocable to such interest but for the provisions of section 265 (relating to disallowance of certain deductions).

(6) *Foreign income.* In the case of a foreign trust, there shall be included the amounts of gross income from sources without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such income but for the provisions of section 265 (1) (relating to disallowance of certain deductions).

(7) *Dividends.* There shall be included the amount of any dividends excluded from gross income pursuant to section 116 (relating to partial exclusion of dividends received).

If the estate or trust is allowed a deduction under section 642 (c), the amount of the modifications specified in paragraphs (5) and (6) shall be reduced to the extent that the amount of income which is paid, permanently set aside, or to be used for the purposes specified in section 642 (c) is deemed to consist of items specified in those paragraphs. For this purpose, such amount shall (in the absence of specific provisions in the governing instrument) be deemed to consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes.

§ 1.643(a)–0 Distributable net income; deduction for distributions; in general.

The term "distributable net income" has no application except in the taxation of estates and trusts and their beneficiaries. It limits the deductions allowable to estates and trusts for amounts paid, credited, or required to be distributed to beneficiaries and is used to determine how much of an amount paid, credited, or required to be distributed to a beneficiary will be includible in his gross income. It is also used to determine the character of distributions to the beneficiaries. Distributable net income means for any taxable year, the taxable income (as defined in section 63) of the estate or trust, computed with the modifications set forth in §§ 1.643 (a)–1 through 1.643 (a)–7.

§ 1.643(a)–1 Deduction for distributions.

The deduction allowable to a trust under section 651 and to an estate or trust under section 661 for amounts paid, credited, or required to be distributed to beneficiaries is not allowed in the computation of distributable net income.

§ 1.643(a)–2 Deduction for personal exemption.

The deduction for personal exemption under section 642(b) is not allowed in the computation of distributable net income.

§ 1.643(a)–3 Capital gains and losses.

(a) Gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income, and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary unless they are:

(1) Allocated to income under the terms of the governing instrument or local law by the fiduciary on its books or by notice to the beneficiary,

(2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or

(3) Utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.

However, if capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642 (c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

(b) Losses from the sale or exchange of capital assets are excluded in computing distributable net income except to the extent that they enter into the determination of any capital gains that are paid, credited, or required to be distributed to any beneficiary during the taxable year (but see § 1.642 (h)–1 with respect to capital loss carryovers in the year of final termination of an estate or trust).

(c) The deduction under section 1202 (relating to capital gains) is taken into account in computing distributable net income to the extent that it is allocable to capital gains which are paid, permanently set aside, or to be used for the purposes specified in section 642 (c). See § 1.642 (c)–2 to determine the extent to which the amount so paid, permanently set aside, or to be used consists of capital gains. The deduction for capital gains provided in section 1202 insofar as it is allocable to the remainder of the capital gains is not taken into account.

(d) The application of this section may be illustrated by the following examples:

Example (1). A trust is created to pay the income to A for life, with a discretionary power in the trustee to invade principal for A's benefit. In the taxable year, $10,000 is realized from the sale of securities at a profit, and $10,000 in excess of income is distributed to A. The capital gain is not allocated to A by the trustee. During the taxable year the trustee received and paid out $5,000 of dividends. No other cash was received or on hand during the taxable year. The capital gain will not ordinarily be included in distributable net income. However, if the trustee follows a regular practice of distributing the exact net proceeds of the sale of trust property, capital gains will be included in distributable net income.

Example (2). The result in example (1) would have been the same if the trustee had been directed to pay an annuity of $15,000 a year to A (instead of being directed to pay the income to A with a discretionary power to distribute principal).

Example (3). The trustee of a trust containing Blackacre and other property is directed to hold Blackacre for ten years, and then sell it and distribute its proceeds to A. Any capital gain realized from the sale of Blackacre will be included in distributable net income.

Example (4). A trust instrument directs that the income shall be paid to A, and that the principal shall be distributed to A when he reaches age 35. All capital gains realized in the year of termination will be included in distributable net income. (See § 1.641 (b)–3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.)

Example (5). If in example (4) the trustee had been directed to distribute half of the principal to A when he reached 35, the capital gain would be included in distributable net income (and in the distribution to A) to the extent the capital gain is allocable to A under the governing instrument and local law. Thus, if the trust assets consisted entirely of 100 shares of corporation M stock and the trustee sold half the shares and distributed the proceeds to A, the entire capital gain would normally be considered as allocated to A. On the other hand, if the trustee sold all the shares and distributed half the proceeds to A, half the capital gain would be considered as allocable to A.

Example (6). If in example (4) the trustee had been directed to pay $10,000 to B before making distribution to A, no portion of the capital gains would be allocable to B since the distribution to B is a gift of a specific sum of money within the meaning of section 663 (a) (1).

§ 1.643(a)–4 Extraordinary dividends and taxable stock dividends.

In the case solely of a trust which qualifies under subpart B (section 651 and following) as a "simple trust", there are excluded from distributable net income extraordinary dividends (whether paid in cash or in kind) or taxable stock dividends which are not distributed or credited to a beneficiary because the fiduciary in good faith determines that under the terms of the governing instrument and applicable local law such dividends are allocable to corpus. See section 665(d) and paragraph (b) of § 1.665 (d)–1 for the treatment of such dividends upon subsequent distribution.

§ 1.643(a)–5 Tax-exempt interest.

(a) There is included in distributable net income any tax-exempt interest excluded from gross income under section 103, reduced by disbursements allocable to such interest which would have been deductible under section 212 but for the provisions of section 265 (relating to disallowance of deductions allocable to tax-exempt income).

(b) If the estate or trust is allowed a charitable contributions deduction under section 642 (c), the amounts specified in paragraph (a) of this section and § 1.643 (a)–6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642 (c). If the governing instrument specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provisions control. In the absence of specific provisions in the governing instrument, an amount to which section 642 (c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642 (c), see examples (1) and (2) of § 1.662 (b)–2 and paragraph (e) of § 1.662 (c)–4.

§ 1.643(a)–6 Foreign income.

In the case of a foreign trust, there is included in distributable net income gross income from sources without the United States, reduced by disbursements allocable to such foreign income which would have been deductible but for the provisions of section 265 (relating to disallowance of deductions allocable to tax-exempt income). See paragraph (b) of § 1.643(a)–5 for rules applicable when an estate or trust is allowed a charitable contributions deduction under section 642(c).

§ 1.643(a)–7 Dividends.

Dividends excluded from gross income under section 116 (relating to partial exclusion of dividends received) are included in distributable net income. For this purpose, adjustments similar to those required by § 1.643(a)–5 with respect to expenses allocable to tax-exempt income and to income included in amounts paid or set aside for charitable purposes are not made. See § 642(c)–2.

§ 1.643(b) Statutory provisions; estates and trusts; definition of income.

SEC. 643. *Definitions applicable to subparts A, B, C, and D.* • • •

(b) *Income.* For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

§ 1.643(b)–1 Definition of "income".

For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Code, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of an estate or trust for the taxable year determined under the terms of its governing instrument and applicable local law. Trust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized for this purpose. For example, if a trust instrument directs that all the trust income shall be paid to A, but defines ordinary dividends and interest as corpus, the trust will not be considered one which under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to "simple" trusts).

§ 1.643(b)–2 Dividends allocated to corpus.

Extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law are not considered "income" for purposes of subpart A, B, C, or D, part I, subchapter J, chapter 1 of the Code. See section 643(a)(4), § 1.643(a)–4, § 1.643(c)–2, section 665(d) and paragraph (b) of § 1.665(d)–1 for the treatment of such items in the computation of distributable net income.

§ 1.643(c) Statutory provisions; estates and trusts; definition of beneficiary.

SEC. 643. *Definitions applicable to subparts A, B, C, and D.* • • •

(c) *Beneficiary.* For purposes of this part, the term "beneficiary" includes heir, legatee, devisee.

§ 1.643(c)–1 Definition of "beneficiary".

An heir, legatee, or devisee (including an estate or trust) is a beneficiary. A trust created under a decedent's will is a beneficiary of the decedent's estate. The following persons are treated as beneficiaries:

(a) Any person with respect to an amount used to discharge or satisfy that person's legal obligation as that term is used in § 1.662 (a)–4.

(b) The grantor of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 677 (b) out of corpus or out of other than income for the taxable year of the trust.

(c) The trustee or cotrustee of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 678 (c) out of corpus or out of other than income for the taxable year of the trust.

§ 1.643(c)–2 Illustration of the provisions of section 643.

(a) The provisions of section 643 may be illustrated by the following example:

Example. (1) Under the terms of the trust instrument, the income of a trust is required to be currently distributed to W during her life. Capital gains are allocable to corpus and all expenses are charges against corpus. During the taxable year the trust has the following items of income and expenses:

Dividends from domestic corporations	$30,000
Extraordinary dividends allocated to corpus by the trustee in good faith	20,000
Taxable interest	10,000
Tax-exempt interest	10,000
Long-term capital gains	10,000
Trustee's commissions and miscellaneous expenses allocable to corpus	5,000

(2) The "income" of the trust determined under section 643 (b) which is currently distributable to W is $50,000, consisting of dividends of $30,000, taxable interest of $10,000, and tax-exempt interest of $10,000. The trustee's commissions and miscellaneous expenses allocable to tax-exempt interest amount to $1,000 (10,000/50,000 × $5,000).

(3) The "distributable net income" determined under section 643 (a) amounts to $45,000, computed as follows:

Dividends from domestic corporations		$30,000
Taxable interest		10,000
Nontaxable interest	$10,000	
Less: Expenses allocable thereto	1,000	9,000
Total		49,000
Less: Expenses ($5,000 less $1,000 allocable to tax-exempt interest)		4,000
Distributable net income		45,000

In determining the distributable net income of $45,000, the taxable income of the trust is computed with the following modifications: No deductions are allowed for distributions to W and for personal exemption of the trust (section 643 (a) (1) and (2)); capital gains allocable to corpus are excluded and the deduction allowable under section 1202 is not taken into account (section 643 (a) (3)); the extraordinary dividends allocated to corpus by the trustee in good faith are excluded (sections 643 (a) (4)); and the tax-exempt interest (as adjusted for expenses) and the dividend exclusion of $50 are included (section 643 (a) (5) and (7)).

(b) See paragraph (c) of the example in § 1.661 (c)–2 for the computation of distributable net income where there is a charitable contributions deduction.

TRUSTS WHICH DISTRIBUTE CURRENT INCOME ONLY

§ 1.651(a) Statutory provisions; trusts which distribute current income only; deduction for amounts required to be distributed currently.

SEC. 651. *Deduction for trusts distributing current income only*—(a) *Deduction.* In the case of any trust the terms of which—

(1) Provide that all of its income is required to be distributed currently, and

(2) Do not provide that any amounts are to be paid, permanently set aside, or used for the purposes specified in section 642 (c) (relating to deduction for charitable, etc., purposes),

there shall be allowed as a deduction in computing the taxable income of the trust the amount of the income for the taxable year which is required to be distributed currently. This section shall not apply in any taxable year in which the trust distributes amounts other than amounts of income described in paragraph (1).

§ 1.651(a)–1 Simple trusts; deduction for distributions; in general.

Section 651 is applicable only to a trust the governing instruments of which:

(a) Requires that the trust distribute all of its income currently for the taxable year, and

(b) Does not provide that any amounts may be paid, permanently set aside, or used in the taxable year for the charitable, etc., purposes specified in section 642 (c),

and does not make any distribution other than of current income. A trust to which section 651 applies is referred to in this part as a "simple" trust. Trusts subject to section 661 are referred to as "complex" trusts. A trust may be a simple trust for one year and a complex trust for another year. It should be noted that under section 651 a trust qualifies as a simple trust in a taxable year in which it is required to distribute all its income currently and makes no other distributions, whether or not distributions of current income are in fact made. On the other hand a trust is not a complex trust by reason of distributions of amounts other than income unless such distributions are in fact made during the taxable year, whether or not they are required in that year.

§ 1.651(a)–2 Income required to be distributed currently.

(a) The determination of whether trust income is required to be distributed currently depends upon the terms of the trust instrument and the applicable local law. For this purpose, if the trust instrument provides that the trustee in determining the distributable income shall first retain a reserve for depreciation or otherwise make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the retention of current income for that purpose will not disqualify the trust from being a "simple" trust. The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust's taxable year. For example: Under the terms of the trust instrument, all of the income is currently distributable to A. The trust reports on the calendar year basis and as a matter of practical necessity makes distribution to A of each quarter's income on the fifteenth day of the month following the close of the quarter. The distribution made by the trust on January 15, 1955, of the income for the fourth quarter of 1954 does not disqualify the trust from treatment in 1955 under section 651, since the income is required to be distributed currently. However, if the terms of a trust require that none of the income be distributed until after the year of its receipt by the trust, the income of the trust is not required to be distributed currently and the trust is not a simple trust. For definition of the term "income" see section 643 (b) and § 1.643(b)–1.

(b) It is immaterial, for purposes of determining whether all the income is required to be distributed currently, that the amount of income allocated to a particular beneficiary is not specified in the instrument. For example, if the fiduciary is required to distribute all the income currently, but has discretion to "sprinkle" the income among a class of beneficiaries, or among named beneficiaries in such amount as he may see fit, all the income is required to be distributed currently, even though the amount distributable to a particular beneficiary is unknown until the fiduciary has exercised his discretion.

(c) If in one taxable year of a trust its income for that year is required or permitted to be accumulated, and in another taxable year its income for the year is required to be distributed currently (and no other amounts are distributed), the trust is a simple trust for the latter year. For example, a trust under which income may be accumulated until a beneficiary is 21 years old, and thereafter must be distributed currently, is a simple trust for taxable years beginning after the beneficiary reaches the age of 21 years in which no other amounts are distributed.

§ 1.651(a)–3 Distribution of amounts other than income.

(a) A trust does not qualify for treatment under section 651 for any taxable year in which it actually distributes corpus. For example, a trust which is required to distribute all of its income currently would not qualify as a simple trust under section 651 in the year of its termination since in that year actual distributions of corpus would be made.

(b) A trust, otherwise qualifying under section 651, which may make a distribution of corpus in the discretion of the trustee, or which is required under the terms of its governing instrument to make a distribution of corpus upon the happening of a specified event, will be disqualified for treatment under section 651 only for the taxable year in which an actual distribution of corpus is made. For example: Under the terms of a trust, which is required to distribute all of its income currently, half of the corpus is to be distributed to beneficiary A when he becomes 30 years of age. The trust reports on the calendar year basis. On December 28, 1954, A becomes 30 years of age and the trustee distributes half of the corpus of the trust to him on January 3, 1955. The trust will be disqualified for treatment under section 651 only for the taxable year 1955, the year in which an actual distribution of corpus is made.

(c) See section 661 and the regulations thereunder for the treatment of trusts which distribute corpus or claim the charitable contributions deduction provided by section 642 (c).

§ 1.651(a)–4 Charitable purposes.

A trust is not considered to be a trust which may pay, permanently set aside, or use any amount for charitable, etc., purposes for any taxable year for which it is not allowed a charitable, etc., deduction under section 642 (c). Therefore, a trust with a remainder to a charitable organization is not disqualified for treatment as a simple trust if either (a) the remainder is subject to a contingency, so that no deduction would be allowed for capital gains or other amounts added to corpus as amounts permanently set aside for a charitable, etc., purpose under section 642 (c), or (b) the trust receives no capital gains or other income added to corpus for the taxable year for which such a deduction would be allowed.

§ 1.651(a)–5 Estates.

Subpart B has no application to an estate.

§ 1.651(b) Statutory provisions; trusts which distribute current income only; limitation on deduction for amounts required to be distributed currently.

SEC. 651. *Deduction for trusts distributing current income only.* * * *

(b) *Limitation on deduction.* If the amount of income required to be distributed currently exceeds the distributable net income of the trust for the taxable year, the deduction shall be limited to the amount of the distributable net income. For this purpose, the computation of distributable net income shall not include items of income which are not included in the gross income of the trust and the deductions allocable thereto.

§ 1.651(b)–1 Deduction for distributions to beneficiaries.

In computing its taxable income, a simple trust is allowed a deduction for the amount of income which is required under the terms of the trust instrument to be distributed currently to beneficiaries. If the amount of income required to be distributed currently exceeds the distributable net income, the deduction allowable to the trust is limited to the amount of the distributable net income. For this purpose the amount of income required to be distributed currently, or distributable net income, whichever is applicable, does not include items of trust income (adjusted for deductions allocable thereto) which are not included in the gross income of the trust. For determination of the character of the income required to be distributed currently, see § 1.652 (b)–2. Accordingly, for the purposes of determining the deduction allowable to the trust under section 651, distributable net income is computed without the modifications specified in paragraphs (5), (6), and (7) of section 643 (a), relating to tax-exempt interest, foreign income, and excluded dividends. For example: Assume that the distributable net income of a trust as computed under section 643 (a) amounts to $99,000 but includes nontaxable income of $9,000. Then distributable net income for the purpose of determining the deduction allowable under section 651 is $90,000 ($99,000 less $9,000 nontaxable income).

§ 1.652(a) Statutory provisions; trusts which distribute current income only; inclusion of amounts in gross income of beneficiaries.

SEC. 652. *Inclusion of amounts in gross income of beneficiaries of trusts distributing current income only*—(a) *Inclusion.* Subject to subsection (b), the amount of income for the taxable year required to be distributed currently by a trust described in section 651 shall be included in the gross income of the beneficiaries to whom the income is required to be distributed, whether distributed or not. If such amount exceeds the distributable net income, there shall be included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income as the amount of income required to be distributed to such beneficiary bears to the amount of income required to be distributed to all beneficiaries.

§ 1.652(a)–1 Simple trusts; inclusion of amounts in income of beneficiaries.

Subject to the rules in §§ 1.652(a)–2 and 1.652(b)–1, a beneficiary of a simple trust includes in his gross income for the taxable year the amounts of income required to be distributed to him for such year, whether or not distributed. Thus, the income of a simple trust is includible in the beneficiary's gross income for the taxable year in which the income is required to be distributed currently even though, as a matter of practical necessity, the income is not distributed until after the close of the taxable year of the trust. See § 1.642 (a)(3)–2 with respect to time of receipt of dividends. See § 1.652 (c)–1 for treatment of amounts required to be distributed where a beneficiary and the trust have different taxable years. The term "income required to be distributed currently" includes income required to be distributed currently which is in fact used to discharge or satisfy any person's

legal obligation as that term is used in § 1.662 (a)–4.

§ 1.652(a)–2 Distributions in excess of distributable net income.

If the amount of income required to be distributed currently to beneficiaries exceeds the distributable net income of the trust (as defined in section 643 (a)), each beneficiary includes in his gross income an amount equivalent to his proportionate share of such distributable net income. Thus, if beneficiary A is to receive two-thirds of the trust income and B is to receive one-third, and the income required to be distributed currently is $99,000, A will receive $66,000 and B, $33,000. However, if the distributable net income, as determined under section 643 (a) is only $90,000, A will include two-thirds ($60,000) of that sum in his gross income, and B will include one-third ($30,000) in his gross income. See §§ 1.652 (b)–1 and 1.652 (b)–2, however, for amounts which are not includible in the gross income of a beneficiary because of their tax-exempt character.

§ 1.652(b) Statutory provisions; trusts which distribute current income only; character of amounts in the hands of beneficiaries.

SEC. 652. *Inclusion of amounts in gross income of beneficiaries of trusts distributing current income only.* • • •

(b) *Character of amounts.* The amounts specified in subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate.

§ 1.652(b)–1 Character of amounts.

In determining the gross income of a beneficiary, the amounts includible under § 1.652 (a)–1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652 (a)–1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 and the dividend exclusion under section 116. The tax treatment of amounts determined under § 1.652 (a)–1 depends upon the beneficiary's status with respect to them, not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

§ 1.652(b)–2 Allocation of income items.

(a) The amounts specified in § 1.652 (a)–1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the trust (as defined in section 643 (a)) as the total of each class bears to such distributable net income, unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For example: Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of $10,000, taxable interest of $10,000, and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest, and $2,000 of tax-exempt interest; B and C will each be deemed to have received $2,500 of dividends, $2,500 of taxable interest, and $1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.

(b) The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation. For example:

(1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.

(2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.

(3) Allocation pursuant to a provision directing the trustee to pay half the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

§ 1.652(b)–3 Allocation of deductions.

Items of deduction of a trust that enter into the computation of distributable net income are to be allocated among the items of income in accordance with the following principles:

(a) All deductible items directly attributable to one class of income (except dividends excluded under section 116) are allocated thereto. For example, repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income are allocated to rental income. See § 1.642 (e)–1 for treatment of depreciation of rental property. Similarly, all expenditures directly attributable to a business carried on by a trust are allocated to the income from such business. If the deductions directly attributable to a particular class of income exceed that income, the excess is applied against other classes of income in the manner provided in paragraph (d) of this section.

(b) The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to nontaxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instance, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643 (a) (3).

(c) Examples of expenses which are considered as not directly attributable to a specific class of income are trustee's commissions, the rental of safe deposit boxes, and State income and personal property taxes.

(d) To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income in the manner provided in paragraph (b) of this section, except that any excess deductions attributable to tax-exempt income (other than dividends excluded under section 116) may not be offset against any other class of income. See section 265 and the regulations thereunder. Thus, if the trust has rents, taxable interest, dividends, and tax-exempt interest, and the deductions directly attributable to the rents exceed the rental income, the excess may be allocated to the taxable interest or dividends in such proportions as the fiduciary may elect. However, if the excess deductions are attributable to the tax-exempt interest, they may not be allocated to either the rents, taxable interest, or dividends.

§ 1.652(c) Statutory provisions; trusts which distribute current income only; inclusion of amounts in gross income of beneficiaries; different taxable years.

SEC. 652. *Inclusion of amounts in gross income of beneficiaries of trusts distributing current income only.* * * *

(c) *Different taxable years.* If the taxable year of a beneficiary is different from that of the trust, the amount which the beneficiary is required to include in gross income in accordance with the provisions of this section shall be based upon the amount of income of the trust for any taxable year or years of the trust ending within or with his taxable year.

§ 1.652(c)–1 Different taxable years.

If a beneficiary has a different taxable year (as defined in section 441 or 442) from the taxable year of the trust, the amount he is required to include in gross income in accordance with section 652 (a) and (b) is based on the income of the trust for any taxable year or years ending with or within his taxable year. This rule applies to taxable years of normal duration as well as to so-called short taxable years. Income of the trust for its taxable year or years is determined in accordance with its method of accounting and without regard to that of the beneficiary.

§ 1.652(c)–2 Death of individual beneficiaries.

If income is required to be distributed currently to a beneficiary, by a trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the income is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under section 652 for the taxable year of the trust in which his last taxable year ends. Thus, the distributable net income of the taxable year of the trust determines the extent to which the income required to be distributed currently to the beneficiary is included in his gross income for his last taxable year or in the gross income of his estate. (Section 652 (c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663 (c)–3 with respect to separate share treatment for the periods before and after the decedent's death. If the trust does not qualify as a simple trust for the taxable year of the trust in which the last taxable year of the beneficiary ends, see section 662 (c) and § 1.662 (c)–2.

§ 1.652(c)–3 Termination of existence of other beneficiaries.

If the existence of a beneficiary which is not an individual terminates, the amount to be included under section 652 (a) in its gross income for its last taxable year is computed with reference to §§ 1.652(c)–1 and 1.652(c)–2 as if the beneficiary were a deceased individual, except that income required to be distributed prior to the termination but actually distributed to the beneficiary's successor in interest is included in the beneficiary's income for its last taxable year.

§ 1.652(c)–4 Illustration of the provisions of sections 651 and 652.

The rules applicable to a trust required to distribute all of its income currently to its beneficiaries may be illustrated by the following example:

Example. (a) Under the terms of a simple trust all of the income is to be distributed equally to beneficiaries A and B and capital gains are to be allocated to corpus. The trust and both beneficiaries file returns on the calendar year basis. No provision is made in the governing instrument with respect to depreciation. During the taxable year 1955, the trust had the following items of income and expense:

Rents	$25,000
Dividends of domestic corporations	50,000
Tax-exempt interest on municipal bonds	25,000
Long-term capital gains	15,000
Taxes and expenses directly attributable to rents	5,000
Trustee's commissions allocable to income account	2,600
Trustee's commissions allocable to principal account	1,300
Depreciation	5,000

(b) The income of the trust for fiduciary accounting purposes is $92,400, computed as follows:

Rents		$25,000
Dividends		50,000
Tax-exempt interest		25,000
Total		100,000
Deductions:		
Expenses directly attributable to rental income	$5,000	
Trustee's commissions allocable to income account	2,600	
		7,600
Income computed under section 643 (b)		92,400

One-half ($46,200) of the income of $92,400 is currently distributable to each beneficiary.

(c) The distributable net income of the trust computed under section 643 (a) is $91,100, determined as follows (cents are disregarded in the computation):

Rents		$25,000
Dividends		50,000
Tax-exempt interest	$25,000	
Less: Expenses allocable thereto (25,000/100,000 × $3,900)	975	
		24,025
Total		99,025
Deductions:		
Expenses directly attributable to rental income	$5,000	
Trustee's commissions ($3,900 less $975 allocable to tax-exempt interest)	2,925	
		7,925
Distributable net income		91,100

In computing the distributable net income of $91,100, the taxable income of the trust was computed with the following modifications: No deductions were allowed for distributions to the beneficiaries and for personal exemption of the trust (section 643 (a) (1) and (2)); capital gains were excluded and no deduction under section 1202 (relating to the 50 percent deduction for long-term capital gains) was taken into account (section 643 (a) (3)); the tax-exempt interest (as adjusted for expenses) and the dividend exclusion of $50 were included (section 643 (a) (5) and (7)). Since all of the income of the trust is required to be currently distributed, no deduction is allowable for depreciation in the absence of specific provisions in the governing instrument providing for the keeping of the trust corpus intact. See section 167 (g) and the regulations thereunder.

(d) The deduction allowable to the trust under section 651 (a) for distributions to the beneficiaries is $67,025, computed as follows:

Distributable net income computed under section 643 (a) (see paragraph (c))		$91,100
Less:		
Tax-exempt interest as adjusted	$24,025	
Dividend exclusion	50	
		$24,075
Distributable net income as determined under section 651 (b)		67,025

Since the amount of the income ($92,400) required to be distributed currently by the trust exceeds the distributable net income ($67,025) as computed under section 651 (b), the deduction allowable under section 651 (a) is limited to the distributable net income of $67,025.

(e) The taxable income of the trust is $7,200 computed as follows:

Rents		$25,000
Dividends ($50,000 less $50 exclusion)		49,950
Long-term capital gains		15,000
Gross income		89,950
Deductions:		
Rental expenses	$5,000	
Trustee's commissions	2,925	
Capital gain deduction	7,500	
Distributions to beneficiaries	67,025	
Personal exemption	300	
		82,750
Taxable income		7,200

The trust is not allowed a deduction for the portion ($975) of the trustee's commissions allocable to tax-exempt interest in computing its taxable income.

(f) In determining the character of the amounts includible in the gross income of A and B, it is assumed that the trustee elects to allocate to rents the expenses not directly attributable to a specific item of income other than the portion ($975) of such expenses allocated to tax-exempt interest. The allocation of expenses among the items of income is shown below:

	Rents	Dividends	Tax-exempt interest	Total
Income for trust accounting purposes	$25,000	$50,000	$25,000	$100,000
Less:				
Rental expenses	5,000	-------	-------	5,000
Trustee's commissions	2,925	-------	975	3,900
Total deductions	7,925	0	975	8,900
Character of amounts in the hands of the beneficiaries	17,075	50,000	24,025	[1] 91,100

[1] Distributable net income.

Inasmuch as the income of the trust is to be distributed equally to A and B, each is deemed to have received one-half of each item of income; that is, rents of $8,537.50,

dividends of $25,000, and tax-exempt interest of $12,012.50. The dividends of $25,000 allocated to each beneficiary are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion provided by section 116 and the dividend received credit allowed under section 34. Also, each beneficiary is allowed a deduction of $2,500 for depreciation of rental property attributable to the portion (one-half) of the income of the trust distributed to him.

ESTATES AND TRUSTS WHICH MAY ACCUMULATE INCOME OR WHICH DISTRIBUTE CORPUS

§ 1.661(a) Statutory provisions; estates and trusts accumulating income or distributing corpus; deduction for amounts required to be distributed currently and other amounts distributed.

SEC. 661. *Deduction for estates and trusts accumulating income or distributing corpus*—(a) *Deduction.* In any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies); the sum of—

(1) Any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and

(2) Any other amounts properly paid or credited or required to be distributed for such taxable year;

but such deduction shall not exceed the distributable net income of the estate or trust.

§ 1.661(a)–1 Estates and trusts accumulating income or distributing corpus; general.

Subpart C, part I, subchapter J, chapter 1 of the Code, is applicable to all decedents' estates and their beneficiaries, and to trusts and their beneficiaries other than trusts subject to the provisions of subpart B of such part I (relating to trusts which distribute current income only, or "simple" trusts). A trust which is required to distribute amounts other than income during the taxable year may be subject to subpart B, and not subpart C, in the absence of an actual distribution of amounts other than income during the taxable year. See §§ 1.651(a)–1 and 1.651(a)–3. A trust to which subpart C is applicable is referred to as a "complex" trust in this part. Section 661 has no application to amounts excluded under section 663(a).

§ 1.661(a)–2 Deduction for distributions to beneficiaries.

(a) In computing the taxable income of an estate or trust there is allowed under section 661(a) as a deduction for distributions to beneficiaries the sum of:

(1) The amount of income for the taxable year which is required to be distributed currently, and

(2) Any other amounts properly paid or credited or required to be distributed for such taxable year.

However, the total amount deductible under section 661 (a) cannot exceed the distributable net income as computed under section 643 (a) and as modified by section 661 (c). See § 1.661 (c)–1.

(b) The term "income required to be distributed currently" includes any amount required to be distributed which may be paid out of income or corpus (such as an annuity), to the extent it is paid out of income for the taxable year. See § 1.651 (a)–2 which sets forth additional rules which are applicable in determining whether income of an estate or trust is required to be distributed currently.

(c) The term "any other amounts properly paid or credited or required to be distributed" includes all amounts properly paid, credited, or required to be distributed by an estate or trust during the taxable year other than income required to be distributed currently. Thus, the term includes the payment of an annuity to the extent it is not paid out of income for the taxable year, and a distribution of property in kind (see paragraph (f) of this section). However, see section 663 (a) and regulations thereunder for distributions which are not included. Where the income of an estate or trust may be accumulated or distributed in the discretion of the fiduciary, or where the fiduciary has a power to distribute corpus to a beneficiary, any such discretionary distribution would qualify under section 661 (a) (2). The term also includes an amount applied or distributed for the support of a dependent of a grantor or of a trustee or cotrustee under the circumstances described in section 677 (b) or section 678 (c) out of corpus or out of other than income for the taxable year.

(d) The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662 (a)–4.

(e) The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" do not include amounts required to be paid by a decedent's estate pursuant to a court order or decree as an allowance or award under local law for the support of the decedent's widow or other dependent for a limited period during the administration of the estate, except to the extent such amounts are payable out of and chargeable to income under the order or decree or local law. The term "any other amounts properly paid or credited or required to be distributed" does not include the value of any interest in real estate owned by a decedent, title to which under local law passes directly from the decedent to his heirs or devisees.

(f) If property is paid, credited, or required to be distributed in kind:

(1) No gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of the distribution, unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed.

(2) In determining the amount deductible by the trust or estate and includible in the gross income of the beneficiary the property distributed in kind is taken into account at its fair market value at the time it was distributed, credited, or required to be distributed.

(3) The basis of the property in the hands of the beneficiary is its fair market value at the time it was paid, credited, or required to be distributed, to the extent such value is included in the gross income of the beneficiary. To the extent that the value of property distributed in kind is not included in the gross income of the beneficiary, its basis in the hands of the beneficiary is governed by the rules in sections 1014 and 1015 and the regulations thereunder. For this purpose, if the total value of cash and property distributed, credited, or required to be distributed in kind to a beneficiary in any taxable year exceeds the amount includible in his gross income for that year, the value of the property other than cash is normally considered as includible in his gross income only to the extent that the amount includible exceeds the cash paid, credited, or required to be distributed to the beneficiary in that year. Further, to the extent that the value of different items of property other than cash is includible in the gross income of a beneficiary in accordance with the preceding sentence, a pro rata portion of the total value of each item of property distributed, credited, or required to be distributed is normally considered as includible in the beneficiary's gross income.

§ 1.661(b) Statutory provisions; estates and trusts accumulating income or distributing corpus; character of amounts distributed to beneficiaries.

SEC. 661. *Deduction for estates and trusts accumulating income or distributing corpus.* * * *.

(b) *Character of amounts distributed.* The amount determined under subsection (a) shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642 (c)) shall be allocated among the items of distributable net income in accordance with the regulations prescribed by the Secretary or his delegate.

§ 1.661(b)–1 Character of amounts distributed; in general.

In the absence of specific provisions in the governing instrument for the allocation of different classes of income, or unless local law requires such an allocation, the amount deductible for distributions to beneficiaries under section 661(a) is treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income. For example, if a trust has distributable net income of $20,000, consisting of $10,000 each of taxable interest and royalties and distributes $10,000 to beneficiary A, the deduction of $10,000 allowable under section 661 (a) is deemed to consist of

$5,000 each of taxable interest and royalties, unless the trust instrument specifically provides for the distribution or accumulation of different classes of income or unless local law requires such an allocation. See also § 1.661 (c)–1.

§ 1.661(b)–2 Character of amounts distributed when charitable contributions are made.

In the application of the rule stated in § 1.661(b)–1, the items of deduction which enter into the computation of distributable net income are allocated among the items of income which enter into the computation of distributable net income in accordance with the rules set forth in § 1.652(b)–3, except that, in the absence of specific provisions in the governing instrument, or unless local law requires a different apportionment, amounts paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) are first ratably apportioned among each class of items of income entering into the computation of the distributable net income of the estate or trust, in accordance with the rules set out in paragraph (b) of § 1.643(a)–5.

§ 1.661(c) Statutory provisions; estates and trusts accumulating income or distributing corpus; limitation on deduction for amounts distributed to beneficiaries.

SEC. 661. *Deduction for estates and trusts accumulating income or distributing corpus.*

* * *

(c) *Limitation on deduction.* No deduction shall be allowed under subsection (a) in respect of any portion of the amount allowed as a deduction under that subsection (without regard to this subsection) which is treated under subsection (b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust.

§ 1.661(c)–1 Limitation on deduction.

An estate or trust is not allowed a deduction under section 661(a) for any amount which is treated under section 661 (b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust. For example, if a trust has distributable net income of $20,000, which is deemed to consist of $10,000 of dividends and $10,000 of tax-exempt interest, and distributes $10,000 to beneficiary A, the deduction allowable under section 661 (a) (computed without regard to section 661 (c)) would amount to $10,000 consisting of $5,000 of dividends and $5,000 of tax-exempt interest. The deduction actually allowable under section 661 (a) as limited by section 661 (c) is $4,975, since no deduction is allowable for the $5,000 of tax-exempt interest and the $25 deemed distributed out of the $50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.

§ 1.661(c)–2 Illustration of the provisions of section 661.

The provisions of section 661 may be illustrated by the following example:

Example. (a) Under the terms of a trust, which reports on the calendar year basis, $10,000 a year is required to be paid out of income to a designated charity. The balance of the income may, in the trustee's discretion, be accumulated or distributed to beneficiary A. Expenses are allocable against income and the trust instrument requires a reserve for depreciation. During the taxable year 1955 the trustee contributes $10,000 to charity and in his discretion distributes $15,000 of income to A. The trust has the following items of income and expense for the taxable year 1955:

Dividends	$10,000
Partially tax-exempt interest	10,000
Fully tax-exempt interest	10,000
Rents	20,000
Rental expenses	2,000
Depreciation of rental property	3,000
Trustee's commissions	5,000

(b) The income of the trust for fiduciary accounting purposes is $40,000, computed as follows:

Dividends		$10,000
Partially tax-exempt interest		10,000
Fully tax-exempt interest		10,000
Rents		20,000
Total		50,000
Less:		
Rental expenses	$2,000	
Depreciation	3,000	
Trustee's commissions	5,000	
		10,000
Income as computed under section 643 (b)		40,000

(c) The distributable net income of the trust as computed under section 643 (a) is $30,000, determined as follows:

Rents		$20,000
Dividends		10,000
Partially tax-exempt interest		10,000
Fully tax-exempt interest	$10,000	
Less:		
Expenses allocable thereto (10,000/50,000×$5,000)	$1,000	
Charitable contributions allocable thereto (10,000/50,000×$10,000)	2,000	
	3,000	
		7,000
Total		47,000
Deductions:		
Rental expenses	$2,000	
Depreciation of rental property	3,000	
Trustee's commissions ($5,000 less $1,000 allocated to tax-exempt interest)	4,000	
Charitable contributions ($10,000 less $2,000 allocated to tax-exempt interest)	8,000	
		17,000
Distributable net income (section 643 (a))		30,000

(d) The character of the amounts distributed under section 661 (a), determined in accordance with the rules prescribed in §§ 1.661 (b)–1 and 1.661 (b)–2 is shown by the following table (for the purpose of this allocation, it is assumed that the trustee elected to allocate the trustee's commissions to rental income except for the amount required to be allocated to tax-exempt interest):

	Rental income	Taxable dividends	Excluded dividends	Partially tax-exempt interest	Tax-exempt interest	Total
Trust income	$20,000	$9,950	$50	$10,000	$10,000	$50,000
Less:						
Charitable contributions	4,000	2,000		2,000	2,000	10,000
Rental expenses	2,000					2,000
Depreciation	3,000					3,000
Trustee's commissions	4,000				1,000	5,000
Total deductions	13,000	2,000	0	2,000	3,000	20,000
Distributable net income	7,000	7,950	50	8,000	7,000	30,000
Amounts deemed distributed under section 661 (a) before applying the limitation of section 661 (c)	3,500	3,975	25	4,000	3,500	15,000

In the absence of specific provisions in the trust instrument for the allocation of different classes of income, the charitable contribution is deemed to consist of a pro rata portion of the gross amount of each item of income of the trust (except dividends excluded under section 116) and the trust is deemed to have distributed to A a pro rata portion (one-half) of each item of income included in distributable net income.

(e) The taxable income of the trust is $11,375 computed as follows:

Rental income		$20,000
Dividends ($10,000 less $50 exclusion)		9,950
Partially tax-exempt interest		10,000
Gross income		39,950
Deductions:		
Rental expenses	$2,000	
Depreciation of rental property	3,000	
Deductions—Continued		
Trustee's commissions	$4,000	
Charitable contributions	8,000	
Distributions to A	11,475	
Personal exemption	100	
		$28,575
Taxable income		11,375

In computing the taxable income of the trust no deduction is allowable for the portions of the charitable contributions deduction ($2,000) and trustee's commissions ($1,000) which are treated under section 661 (b) as attributable to the tax-exempt interest excludable from gross income. Also, of the dividends of $4,000 deemed to have been distributed to A under section 661 (a), $25 (25/50ths of $50) is deemed to have been distributed from the excluded dividends and is not an allowable deduction to the trust. Accordingly, the deduction allowable under section 661 is deemed to be composed of

$3,500 rental income, $3,975 of dividends, and $4,000 partially tax-exempt interest. No deduction is allowable for the portion of tax-exempt interest or for the portion of the excluded dividends deemed to have been distributed to the beneficiary.

(f) The trust is entitled to the credit allowed by section 34 with respect to dividends of $5,975 ($9,950 less $3,975 distributed to A) included in gross income. Also, the trust is allowed the credit provided by section 35 with respect to partially tax-exempt interest of $6,000 ($10,000 less $4,000 deemed distributed to A) included in gross income.

(g) Dividends of $4,000 allocable to A are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion under section 116 and the dividend received credit under section 34.

§ 1.662(a) Statutory provisions; estates and trusts which may accumulate income or which distribute corpus; inclusion of amounts in gross income of beneficiaries.

SEC. 662. *Inclusion of amounts in gross income of beneficiaries of estates and trusts accumulating income or distributing corpus*—(a) *Inclusion.* Subject to subsection (b), there shall be included in the gross income of a beneficiary to whom an amount specified in section 661 (a) is paid, credited, or required to be distributed (by an estate or trust described in section 661), the sum of the following amounts:

(1) *Amounts required to be distributed currently.* The amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not. If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (computed without the deduction allowed by section 642 (c), relating to deduction for charitable, etc., purposes) of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to such beneficiary bears to the amount required to be distributed currently to all beneficiaries. For purposes of this section, the phrase "the amount of income for the taxable year required to be distributed currently" includes any amount required to be paid out of income or corpus to the extent such amount is paid out of income for such taxable year.

(2) *Other amounts distributed.* All other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year. If the sum of—

(A) The amount of income for the taxable year required to be distributed currently to all beneficiaries, and

(B) All other amounts properly paid, credited, or required to be distributed to all beneficiaries

exceeds the distributable net income of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (reduced by the amounts specified in (A)) as the other amounts properly paid, credited or required to be distributed to the beneficiary bear to the other amounts properly paid, credited, or required to be distributed to all beneficiaries.

§ 1.662(a)–1 Inclusion of amounts in gross income of beneficiaries of estates and complex trusts; general.

There is included in the gross income of a beneficiary of an estate or complex trust the sum of:

(1) Amounts of income required to be distributed currently to him, and

(2) All other amounts properly paid, credited, or required to be distributed to him

by the estate or trust. The preceding sentence is subject to the rules contained in § 1.662 (a)–2 (relating to currently distributable income), § 1.662 (a)–3 (relating to other amounts distributed), and §§ 1.662 (b)–1 and 1.662 (b)–2 (relating to character of amounts). Section 662 has no application to amounts excluded under section 663 (a).

§ 1.662(a)–2 Currently distributable income.

(a) There is first included in the gross income of each beneficiary under section 662(a)(1) the amount of income for the taxable year of the estate or trust required to be distributed currently to him, subject to the provisions of paragraph (b) of this section. Such amount is included in the beneficiary's gross income whether or not it is actually distributed.

(b) If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (as defined in section 643 (a) but computed without taking into account the payment, crediting, or setting aside of an amount for which a charitable contributions deduction is allowable under section 642 (c)) of the estate or trust, then there is included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to the beneficiary bears to the amount required to be distributed currently to all beneficiaries.

(c) The phrase "the amount of income for the taxable year required to be distributed currently" includes any amount required to be paid out of income or corpus to the extent the amount is satisfied out of income for the taxable year. Thus, an annuity required to be paid in all events (either out of income or corpus) would qualify as income required to be distributed currently to the extent there is income (as defined in section 643 (b)) not paid, credited, or required to be distributed to other beneficiaries for the taxable year. If an annuity or a portion of an annuity is deemed under this paragraph to be income required to be distributed currently, it is treated in all respects in the same manner as an amount of income actually required to be distributed currently.

(d) If an annuity is paid, credited, or required to be distributed tax free, that is, under a provision whereby the executor or trustee will pay the income tax of the annuitant resulting from the receipt of the annuity, the payment of or for the tax by the executor or trustee will be treated as income paid, credited, or required to be distributed currently to the extent it is made out of income.

(e) The application of the rules stated in this section may be illustrated by the following examples:

Example (1). (1) Assume that under the terms of the trust instrument $5,000 is to be paid to X charity out of income each year; that $20,000 of income is currently distributable to A; and that an annuity of $12,000 is to be paid to B out of income or corpus. All expenses are charges against income and capital gains are allocable to corpus. During the taxable year the trust had income of $30,000 (after the payment of expenses) derived from taxable interest and made the payments to X charity and distributions to A and B as required by the governing instrument.

(2) The amounts treated as distributed currently under section 662 (a) (1) total $25,000 ($20,000 to A and $5,000 to B). Since the charitable contribution is out of income, the amount of income available for B's annuity is only $5,000. The distributable net income of the trust computed under section 643 (a) without taking into consideration the charitable contributions deduction of $5,000 as provided by section 661 (a) (1), is $30,000. Since the amounts treated as distributed currently of $25,000 do not exceed the distributable net income (as modified) of $30,000, A is required to include $20,000 in his gross income and B is required to include $5,000 in his gross income under section 662 (a) (1).

Example (2). Assume the same facts as in paragraph (1) of example (1), except that the trust has, in addition, $10,000 of administration expenses, commissions, etc., chargeable to corpus. The amounts treated as distributed currently under section 662 (a) (1) total $25,000 ($20,000 to A and $5,000 to B), since trust income under section 643 (b) remains the same as in example (1). Distributable net income of the trust computed under section 643 (a) but without taking into account the charitable contributions deduction of $5,000 as provided by section 662 (a) (1) is only $20,000. Since the amounts treated as distributed currently of $25,000 exceed the distributable net income (as so computed) of $20,000, A is required to include $16,000 (20,000/25,000 of $20,000) in his gross income and B is required to include $4,000 (5,000/25,000 of $20,000) in his gross income under section 662 (a) (1). Because A and B are beneficiaries of amounts of income required to be distributed currently, they do not benefit from the reduction of distributable net income by the charitable contributions deduction.

§ 1.662(a)–3 Other amounts distributed.

(a) There is included in the gross income of a beneficiary under section 662 (a) (2) any amount properly paid, credited, or required to be distributed to the beneficiary for the taxable year, other than (1) income required to be distributed currently, as determined under § 1.662 (a)–2, (2) amounts excluded under section 663 (a) and the regulations thereunder, and (3) amounts in excess of distributable net income (see paragraph (c) of this section). An amount which is credited or required to be distributed is included in the gross income of a beneficiary whether or not it is actually distributed.

(b) Some of the payments to be included under paragraph (a) of this section are: (1) A distribution made to a beneficiary in the discretion of the fiduciary; (2) a distribution required by the terms of the governing instrument upon the happening of a specified event; (3) an annuity which is required to be paid in all events but which is payable only out of corpus; (4) a distribution of property in kind (see paragraph (f) of § 1.661 (a)–2); and (5) an amount applied or distributed for the support of a dependent of a grantor or a trustee or cotrustee

under the circumstances specified in section 677 (b) or section 678 (c) out of corpus or out of other than income for the taxable year.

(c) If the sum of the amounts of income required to be distributed currently (as determined under § 1.662 (a)–2) and other amounts properly paid, credited, or required to be distributed (as determined under paragraph (a) of this section) exceeds distributable net income (as defined in section 643 (a)), then such other amounts properly paid, credited, or required to be distributed are included in gross income of the beneficiary but only to the extent of the excess of such distributable net income over the amounts of income required to be distributed currently. If the other amounts are paid, credited, or required to be distributed to more than one beneficiary, each beneficiary includes in gross income his proportionate share of the amount includible in gross income pursuant to the preceding sentence. The proportionate share is an amount which bears the same ratio to distributable net income (reduced by amounts of income required to be distributed currently) as the other amounts (as determined under paragraphs (a) and (d) of this section) distributed to the beneficiary bear to the other amounts distributed to all beneficiaries. For treatment of excess distributions by trusts, see sections 665 to 668, inclusive, and the regulations thereunder.

(d) The application of the rules stated in this section may be illustrated by the following example:

Example. The terms of a trust require the distribution annually of $10,000 of income to A. If any income remains, it may be accumulated or distributed to B, C, and D in amounts in the trustee's discretion. He may also invade corpus for the benefit of A, B, C, or D. In the taxable year, the trust has $20,000 of income after the deduction of all expenses. Distributable net income is $20,000. The trustee distributes $10,000 of income to A. Of the remaining $10,000 of income, he distributes $3,000 each to B, C, and D, and also distributes an additional $5,000 to A. A includes $10,000 in income under section 662 (a) (1). The "other amounts distributed" amount to $14,000, includible in the income of the recipients to the extent of $10,000, distributable net income less the income currently distributable to A. A will include an additional $3,571 (5,000/14,000 × $10,000) in income under this section, and B, C, and D will each include $2,143 (3,000/14,000 × $10,000).

§ 1.662(a)–4 Amounts used in discharge of a legal obligation.

Any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under section 662(a)(1) or (2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which section 71 (relating to alimony payments) or section 682 (relating to income of a trust in case of divorce, etc.) applies. The term "legal obligation" includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. For example, a parent has a "legal obligatiion" within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him. On the other hand, if under local law a mother may use the resources of a child for the child's support in lieu of supporting him herself, no obligation of support exists within the meaning of this paragraph, whether or not income is actually used for support. Similarly, since under local law a child ordinarily is obligated to support his parent only if the parent's earnings and resources are insufficient for the purpose, no obligation exists whether or not the parent's earnings and resources are sufficient. In any event, the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. In the case of a parent's obligation to support his child, to the extent that the parent's legal obligation of support, including education, is determined under local law by the family's station in life and by the means of the parent, it is to be determined without consideration of the trust income in question.

§ 1.662(b) Statutory provisions; estates and trusts which may accumulate income or which distribute corpus; character of amounts in the hands of beneficiaries.

SEC. 662. *Inclusion of amounts in gross income of beneficiaries of estates and trusts accumulating income or distributing corpus.* * * *

(b) *Character of amounts.* The amounts determined under subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642 (c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642 (c) which is not attributable to income of the taxable year.

§ 1.662(b)–1 Character of amounts; when no charitable contributions are made.

In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)–1 through 1.662 (a)–4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652 (b)–1 shall apply.

§ 1.662(b)–2 Character of amounts; when charitable contributions are made.

When a charitable contribution is made, the principles contained in §§ 1.652 (b)–1 and 1.662 (b)–1 generally apply. However, before the allocation of other deductions among the items of distributable net income, the charitable contributions deduction allowed under section 642 (c) is (in the absence of specific allocation under the terms of the governing instrument or the requirement under local law of a different allocation) allocated among the classes of income entering into the computation of estate or trust income in accordance with the rules set forth in paragraph (b) of § 1.643 (a)–5. In the application of the preceding sentence, for the purpose of allocating items of income and deductions to beneficiaries to whom income is required to be distributed currently, the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently. The application of this section may be illustrated by the following examples (of which example (1) is illustrative of the preceding sentence):

Example (1). (a) A trust instrument provides that $30,000 of its income must be distributed currently to A, and the balance may either be distributed to B, distributed to a designated charity, or accumulated. Accumulated income may be distributed to B and to the charity. The trust for its taxable year has $40,000 of taxable interest and $10,000 of tax-exempt income, with no expenses. The trustee distributed $30,000 to A, $50,000 to charity X, and $10,000 to B.

(b) Distributable net income for the purpose of determining the character of the distribution to A is $30,000 (the charitable contributions deduction, for this purpose, being taken into account only to the extent of $20,000, the difference between the income of the trust for the taxable year, $50,000, and the amount required to be distributed currently, $30,000).

(c) The charitable contributions deduction taken into account, $20,000, is allocated proportionately to the items of income of the trust, $16,000 to taxable interest and $4,000 to tax-exempt income.

(d) Under section 662 (a) (1), the amount of income required to be distributed currently to A is $30,000, which consists of the balance of these items, $24,000 of taxable interest and $6,000 of tax-exempt income.

(e) In determining the amount to be included in the gross income of B under section 662 for the taxable year, however, the entire charitable contributions deduction is taken into account, with the result that there is no distributable net income and therefore no amount to be included in gross income.

(f) See subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code for application of the throwback provisions to the distribution made to B.

Example (2). The net income of a trust is payable to A for life, with the remainder to a charitable organization. Under the terms of the trust instrument and local law capital gains are added to corpus. During

the taxable year the trust receives dividends of $10,000 and realized a long-term capital gain of $10,000, for which a long-term capital gain deduction of $5,000 is allowed under section 1202. Since under the trust instrument and local law the capital gains are allocated to the charitable organization, and since the capital gain deduction is directly attributable to the capital gain, the charitable contributions deduction and the capital gain deduction are both allocable to the capital gain, and dividends in the amount of $10,000 are allocable to A.

§ 1.662(c) Statutory provisions; estates and trusts which may accumulate income or which distribute corpus; different taxable years.

SEC. 662. *Inclusion of amounts in gross income of beneficiaries of estates and trusts accumulating income or distributing corpus.* • • •

(c) *Different taxable years.* If the taxable year of a beneficiary is different from that of the estate or trust, the amount to be included in the gross income of the beneficiary shall be based on the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary during any taxable year or years of the estate or trust ending within or with his taxable year.

§ 1.662(c)–1 Different taxable years.

If a beneficiary has a different taxable year (as defined in section 441 or 442) from the taxable year of an estate or trust, the amount he is required to include in gross income in accordance with section 662 (a) and (b) is based upon the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary for any taxable year or years of the estate or trust ending with or within his taxable year. This rule applies as to so-called short taxable years as well as taxable years of normal duration. Income of an estate or trust for its taxable year or years is determined in accordance with its method of accounting and without regard to that of the beneficiary.

§ 1.662(c)–2 Death of individual beneficiary.

If an amount specified in section 662 (a)(1) or (2) is paid, credited, or required to be distributed by an estate or trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the amount is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under section 662 for the taxable year of the estate or trust in which his last taxable year ends. Thus, the distributable net income and the amounts paid, credited, or required to be distributed for the taxable year of the estate or trust, determine the extent to which the amounts paid, credited, or required to be distributed to the beneficiary are included in his gross income for his last taxable year or in the gross income of his estate. (Section 662(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)–3 with respect to separate share treatment for the periods before and after the death of a trust's beneficiary.

§ 1.662(c)–3 Termination of existence of other beneficiaries.

If the existence of a beneficiary which is not an individual terminates, the amount to be included under section 662(a) in its gross income for the last taxable year is computed with reference to §§ 1.662(c)–1 and 1.662(c)–2 as if the beneficiary were a deceased individual, except that income required to be distributed prior to the termination but actually distributed to the beneficiary's successor in interest is included in the beneficiary's income for its last taxable year.

§ 1.662(c)–4 Illustration of the provisions of sections 661 and 662.

The provisions of sections 661 and 662 may be illustrated in general by the following example:

Example. (a) Under the terms of a testamentary trust one-half of the trust income is to be distributed currently to W, the decedent's wife, for her life. The remaining trust income may, in the trustee's discretion, either be paid to D, the grantor's daughter, paid to designated charities, or accumulated. The trust is to terminate at the death of W and the principal will then be payable to D. No provision is made in the trust instrument with respect to depreciation of rental property. Capital gains are allocable to the principal account under the applicable local law. The trust and both beneficiaries file returns on the calendar year basis. The records of the fiduciary show the following items of income and deduction for the taxable year 1955:

Rents	$50,000
Dividends of domestic corporations	50,000
Tax-exempt interest	20,000
Partially tax-exempt interest	10,000
Capital gains (long term)	20,000
Depreciation of rental property	10,000
Expenses attributable to rental income	15,400
Trustee's commissions allocable to income account	2,800
Trustee's commissions allocable to principal account	1,100

(b) The income for trust accounting purposes is $111,800, and the trustee distributes one-half ($55,900) to W and in his discretion makes a contribution of one-quarter ($27,950) to charity X and distributes the remaining one-quarter ($27,950) to D. The total of the distributions to beneficiaries is $83,850, consisting of (1) income required to be distributed currently to W of $55,900 and (2) other amounts properly paid or credited to D of $27,950. The income for trust accounting purposes of $111,800 is determined as follows:

Rents		$50,000
Dividends		50,000
Tax-exempt interest		20,000
Partially tax-exempt interest		10,000
Total		130,000
Less:		
Rental expenses	$15,400	
Trustee's commissions allocable to income account	2,800	
		18,200
Income as computed under section 643 (b)		111,800

(c) The distributable net income of the trust as computed under section 643 (a) is $82,750, determined as follows:

Rents		$50,000
Dividends		50,000
Partially tax-exempt interest		10,000
Tax-exempt interest	$20,000	
Less:		
Trustee's commissions allocable thereto (20,000/130,000 of $3,900)	$600	
Charitable contributions allocable thereto (20,000/130,000 of $27,950)	4,300	
	4,900	
		15,100
Total		125,100
Deductions:		
Rental expenses	$15,400	
Trustee's commissions ($3,900 less $600 allocated to tax-exempt interest)	3,300	
Charitable deduction ($27,950 less $4,300 attributable to tax-exempt interest)	23,650	
		42,350
Distributable net income		82,750

In computing the distributable net income of $82,750, the taxable income of the trust was computed with the following modifications: No deductions were allowed for distributions to beneficiaries and for personal exemption of the trust (section 643 (a) (1) and (2)); capital gains were excluded and no deduction under section 1202 (relating to the 50 percent deduction for long-term capital gains) was taken into account (section 643 (a) (3)); and the tax-exempt interest (as adjusted for expenses and charitable contributions) and the dividend exclusion of $50 were included (section 643 (a) (5) and (7)).

(d) Inasmuch as the distributable net income of $82,750 as determined under section 643 (a) is less than the sum of the amounts distributed to W and D of $83,850, the deduction allowable to the trust under section 661 (a) is such distributable net income as modified under section 661 (c) to exclude therefrom the items of income not included in the gross income of the trust, as follows:

Distributable net income	$82,750
Less:	
Tax-exempt interest (as adjusted for expenses and the charitable contributions)	$15,100

Less—Continued		
Dividend exclusion allowable under section 116	$50	
		$15,150
Deduction allowable under section 661 (a)		67,600

(c) For the purpose of determining the character of the amounts deductible under section 642 (c) and section 661 (a), the trustee elected to offset the trustee's commissions (other than the portion required to be allocated to tax-exempt interest) against the rental income. The following table shows the determination of the character of the amounts deemed distributed to beneficiaries and contributed to charity:

	Rents	Taxable dividends	Excluded dividends	Tax-exempt interest	Partially tax-exempt interest	Total
Trust income	$50,000	$40,950	$50	$20,000	$10,000	$130,000
Less:						
Charitable contribution	10,750	10,750	----------	4,300	2,150	27,950
Rental expenses	15,400	----------	----------	----------	----------	15,400
Trustee's commissions	3,300	----------	----------	600	----------	3,900
Total deductions	29,450	10,750	0	4,900	2,150	47,250
Amounts distributable to beneficiaries	20,550	39,200	50	15,100	7,850	82,750

The character of the charitable contribution is determined by multiplying the total charitable contribution ($27,950) by a fraction consisting of each item of trust income, respectively, over the total trust income, except that no part of the dividends excluded from gross income are deemed included in the charitable contribution. For example, the charitable contribution is deemed to consist of rents of $10,750 (50,000/130,000 × $27,950).

(f) The taxable income of the trust is $9,900 determined as follows:

Rental income		$50,000
Dividends ($50,000 less $50 exclusion)		49,950
Partially tax-exempt interest		10,000
Capital gains		20,000
Gross income		129,950
Deductions:		
Rental expenses	$15,400	
Trustee's commissions	3,300	
Charitable contributions	23,650	
Capital gain deduction	10,000	
Distributions to beneficiaries	67,600	
Personal exemption	100	
		120,050
Taxable income		9,900

(g) In computing the amount includible in W's gross income under section 662 (a) (1), the $55,900 distribution to her is deemed to be composed of the following proportions of the items of income deemed to have been distributed to the beneficiaries by the trust (see paragraph (e) of this example):

Rents (20,550/82,750 × $55,900)	$13,882
Dividends (39,250/82,750 × $55,900)	26,515
Partially tax-exempt interest (7,850/82,750 × $55,900)	5,303
Tax-exempt interest (15,100/82,750 × $55,900)	10,200
Total	55,900

Accordingly, W will exclude $10,200 of tax-exempt interest from gross income and will receive the credits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively, with respect to the dividends and partially tax-exempt interest deemed to have been distributed to her, her share of the dividends being aggregated with other dividends received by her for purposes of the dividend credit and exclusion. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her; that is, one-half of the total depreciation deduction, or $5,000.

(h) Inasmuch as the sum of the amount of income required to be distributed currently to W ($55,900) and the other amounts properly paid, credited, or required to be distributed to D ($27,950) exceeds the distributable net income ($82,750) of the trust as determined under section 643 (a), D is deemed to have received $26,850 ($82,750 less $55,900) for income tax purposes. The character of the amounts deemed distributed to her is determined as follows:

Rents (20,550/82,750 × $26,850)	$6,668
Dividends (39,250/82,750 × $26,850)	12,735
Partially tax-exempt interest (7,850/82,750 × $26,850)	2,547
Tax-exempt interest (15,100/82,750 × $26,850)	4,900
Total	26,850

Accordingly, D will exclude $4,900 of tax-exempt interest from gross income and will receive the credits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively, with respect to the dividends and partially tax-exempt interest deemed to have been distributed to her, her share of the dividends being aggregated with other dividends received by her for purposes of the dividend credit and exclusion. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her; that is, one-fourth of the total depreciation deduction, or $2,500.

(i) [Reserved]

(j) The remaining $2,500 of the depreciation deduction is allocated to the amount distributed to charity X and is hence nondeductible by the trust, W, or D. (See § 1.642 (c)-1.)

§ 1.663(a) Statutory provisions; estates and complex trusts; special rules applicable to sections 661 and 662; exclusions.

SEC. 663. *Special rules applicable to sections 661 and 662*—(a) *Exclusions.* There shall not be included as amounts falling within section 661 (a) or 662 (a)—

(1) *Gifts, bequests, etc.* Any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments. For this purpose an amount which can be paid or credited only from the income of the estate or trust shall not be considered as a gift or bequest of a specific sum of money.

(2) *Charitable, etc., distributions.* Any amount paid or permanently set aside or otherwise qualifying for the deduction provided in section 642 (c) (computed without regard to section 681).

(3) *Denial of double deduction.* Any amount paid, credited, or distributed in the taxable year, if section 651 or section 661 applied to such amount for a preceding taxable year of an estate or trust because credited or required to be distributed in such preceding taxable year.

§ 1.663(a)-1 Special rules applicable to sections 661 and 662; exclusions; gifts, bequests, etc.

(a) *In general.* A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under section 661 and is not included in the gross income of a beneficiary under section 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments. Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see paragraph (b) of this section), and (2) the terms of the governing instrument must not provide for its payment in more than three installments (see paragraph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

(b) *Definition of a gift or bequest of a specific sum of money or of specific property.* (1) In order to qualify as a gift or bequest of a specific sum of money or of specific property under section 663 (a), the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust. For example, bequests to a decedent's son of the decedent's interest in a partnership and to his daughter of a sum of money equal to the value of the partnership interest are bequests of specific property and of a specific sum of money, respectively. On the other hand, a bequest to the decedent's spouse of money or property, to be selected by the decedent's executor, equal in value to a fraction of the decedent's "adjusted gross estate" is neither a bequest of a specific sum of money or of specific property. The identity of the property and the amount of money specified in the preceding sentence are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges, neither of which are facts existing on the date of the decedent's death. It is immaterial that the value of the bequest is determinable after the decedent's death before the bequest is satisfied (so that gain or loss may be realized by the estate in the transfer of property in satisfaction of it).

(2) The following amounts are not considered as gifts or bequests of a sum of money or of specific property within the meaning of this paragraph:

(i) An amount which can be paid or credited only from the income of an estate or trust, whether from the income for the year of payment or crediting, or from the income accumulated from a prior year;

(ii) An annuity, or periodic gifts of specific property in lieu of or having the effect of an annuity;

(iii) A residuary estate or the corpus of a trust; or

(iv) A gift or bequest paid in a lump sum or in not more than three installments, if the gift or bequest is required to be paid in more than three installments under the terms of the governing instrument.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples, in which it is assumed that the gift or bequest is not required to be made in more than three installments (see paragraph (c)):

Example (1). Under the terms of a will, a legacy of $5,000 was left to A, 1,000 shares of X company stock was left to W, and the balance of the estate was to be divided equally between W and X. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $25,000 during the taxable year 1954, which was accumulated and added to corpus for estate accounting purposes. During the taxable year, the executor paid the legacy of $5,000 in a lump sum to A and transferred the X company stock to W. No other distributions to beneficiaries were made during the taxable year. The distributions to A and W qualify as exclusions within the meaning of section 663 (a) (1).

Example (2). Under the terms of a will, the testator's estate was to be divided equally between A and B. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $50,000 for the taxable year 1954. In accordance with an agreement among the beneficiaries that part of the assets of the estate would be distributed in kind to the beneficiaries, stock in corporation X was distributed to A during 1954. The fair market value of the stock was $40,000 on the date of distribution. No other distribution was made during the year. The distribution does not qualify as an exclusion within the meaning of section 663 (a) (1), since it is not a specific gift to A required by the terms of the will. Accordingly, the fair market value of the property ($40,000) represents a distribution within the meaning of section 661 (a) and section 662 (a) (see paragraph (c) of § 1.661 (a)-2).

Example (3). Under the terms of a trust instrument, income is to be accumulated during the minority of A. Upon A's reaching the age of 21, $10,000 is to be distributed to B out of income or corpus. Also at that time, $10,000 is to be distributed to C out of the accumulated income and the remainder of the accumulations are to be paid to A. A is then to receive all the income until he is 25, when the trust is to terminate. Only the distribution to B would qualify for exclusion under section 663 (a) (1).

(4) A gift or bequest of a specific sum of money or of specific property is not disqualified under this paragraph solely because its payment is subject to a condition. For example, provision for a payment by a trust to benficiary A of $10,000 when he reaches age 25, and $10,000 when he reaches age 30, with payment over to B of any amount not paid to A because of his death, is a gift to A of a specific sum of money payable in two installments, within the meaning of this paragraph, even though the exact amount payable to A cannot be ascertained with certainty under the terms of the trust instrument.

(c) *Installment payments.* (1) In determining whether a gift or bequest of a specific sum of money or of specific property, as defined in paragraph (b) of this section, is required to be paid or credited to a particular beneficiary in more than three installments—

(i) Gifts or bequests of articles for personal use (such as personal and household effects, automobiles, and the like) are disregarded.

(ii) Specifically devised real property, the title to which passes directly from the decedent to the devisee under local law, is not taken into account, since it would not constitute an amount paid, credited, or required to be distributed under section 661 (see paragraph (e) of § 1.661 (a)-2).

(iii) All gifts and bequests under a decedent's will (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) for which no time of payment or crediting is specified, and which are to be paid or credited in the ordinary course of administration of the decedent's estate, are considered as required to be paid or credited in a single installment.

(iv) All gifts and bequests (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) payable at any one specified time under the terms of the governing instrument are taken into account as a single installment.

For purposes of determining the number of installments paid or credited to a particular beneficiary, a decedent's estate and a testamentary trust shall each be treated as a separate entity.

(2) The application of the rules stated in subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) Under the terms of a decedent's will, $10,000 in cash, household furniture, a watch, an automobile, 100 shares of X company stock, 1,000 bushels of grain, 500 head of cattle, and a farm (title to which passed directly to A under local law) are bequeathed or devised outright to A. The will also provides for the creation of a trust for the benefit of A, under the terms of which there are required to be distributed to A, $10,000 in cash and 100 shares of Y company stock when he reaches 25 years of age, $25,000 in cash and 200 shares of Y company stock when he reaches 30 years of age, and $50,000 in cash and 300 shares of Y company stock when he reaches 35 years of age.

(ii) The furniture, watch, automobile, and the farm are excluded in determining whether any gift or bequest is required to be paid or credited to A in more than three installments. These items qualify for the exclusion under section 663 (a) (1) regardless of the treatment of the other items of property bequeathed to A.

(iii) The $10,000 in cash, the shares of X company stock, the grain, the cattle and the assets required to create the trust, to be paid or credited by the estate to A and the trust are considered as required to be paid or credited in a single installment to each, regardless of the manner of payment or distribution by the executor, since no time of payment or crediting is specified in the will. The $10,000 in cash and shares of Y company stock required to be distributed by the trust to A when he is 25 years old are considered as required to be paid or distributed as one installment under the trust. Likewise, the distributions to be made by the trust to A when he is 30 and 35 years old are each considered as one installment under the trust. Since the total number of installments to be made by the estate does not exceed three, all of the items of money and property distributed by the estate qualify for the exclusion under section 663 (a) (1). Similarly, the three distributions by the trust qualify.

Example (2). Assume the same facts as in example (1), except that another distribution of a specified sum of money is required to be made by the trust to A when he becomes 40 years old. This distribution would also qualify as an installment, thus making four installments in all under the trust. None of the gifts to A under the trust would qualify for the exclusion under section 663 (a) (1). The situation as to the estate, however, would not be changed.

Example (3). A trust instrument provides that A and B are each to receive $75,000 in installments of $25,000, to be paid in alternate years. The trustee distributes $25,000 to A in 1954, 1956, and 1958, and to B in 1955, 1957, and 1959. The gifts to A and B qualify for exclusion under section 663 (a) (1), although a total of six payments is made. The gifts of $75,000 to each beneficiary are to be separately treated.

§ 1.663(a)-2 Charitable, etc., distributions.

Any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642 (c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under section 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under section 662. Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642 (c). For purposes of this section, the deduction provided in section 642 (c) is computed without regard to the limitation provided by section 681 (concerning unrelated business income and prohibited transactions).

§ 1.663(a)-3 Denial of double deduction.

No amount deemed to have been distributed to a beneficiary in a preceding year under section 651 or 661 is included in amounts falling within section 661 (a) or 662 (a). For example, assume that all of the income of a trust is required to be distributed currently to beneficiary A and both the trust and A report on the calendar year basis. For administrative convenience, the trustee distributes in January and February 1956 a portion of the income of the trust required to be distributed in 1955. The portion of the income for 1955 which was distributed by the trust in 1956 may not be claimed as a deduction by the trust for 1956 since it is deductible by the trust and includible in A's gross income for the taxable year 1955.

§ 1.663(b) Statutory provisions; estates and complex trusts; special rules applicable to sections 661 and 662; distributions in first sixty-five days of taxable year.

SEC. 663. *Special rules applicable to sections 661 and 662.* * * *

(b) *Distributions in first sixty-five days of taxable year—*(1) *General rule.* If within the first 65 days of any taxable year of a trust,

an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year.

(2) *Limitation.* This subsection shall apply only to a trust—

(A) Which was in existence prior to January 1, 1954,

(B) Which under the terms of its governing instrument, may not distribute in any taxable year amounts in excess of the income of the preceding taxable year, and

(C) On behalf of which the fiduciary elects to have this subsection apply.

The election authorized by subparagraph (C) shall be made for the first taxable year to which this part is applicable in accordance with such regulations as the Secretary or his delegate shall prescribe and shall be made not later than the time prescribed by law for filing the return for such year (including extensions thereof). If such election is made with respect to a taxable year, this subsection shall apply to all amounts properly paid or credited within the first 65 days of all subsequent taxable years of such trust.

§ 1.663(b)–1 Distributions in first sixty-five days of taxable year; scope.

The fiduciary of a trust may elect under section 663(b) to treat distributions within the first 65 days of the taxable year of the trust as amounts which were paid or credited on the last day of the preceding taxable year, if:

(a) The trust was in existence prior to January 1, 1954;

(b) An amount in excess of the income of the immediately preceding taxable year may not (under the terms of the governing instrument) be distributed in any taxable year; and

(c) The fiduciary elects (as provided in § 1.663 (b)–2) to have section 663 (b) apply.

§ 1.663(b)–2 Election.

(a) The election under section 663(b) shall be made in a statement attached to the return for the first taxable year of the trust subject to the Internal Revenue Code of 1954. The election must be made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

(b) If an election is made by a fiduciary, the election is irrevocable for the taxable year for which the election is made and for all future taxable years.

(c) If an election is made with respect to a taxable year, this section applies to all amounts properly paid or credited within the first 65 days of such year and all subsequent taxable years of the trust.

§ 1.663(c) Statutory provisions; estates and complex trusts; special rules applicable to section 661 and 662; separate shares treated as separate trusts.

SEC. 663. *Special rules applicable to sections 661 and 662.* • • •

(c) *Separate shares treated as separate trusts.* For the sole purpose of determining the amount of distributable net income in the application of sections 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts. The existence of such substantially separate and independent shares and the manner of treatment as separate trusts, including the application of subpart D, shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

§ 1.663(c)–1 Separate shares treated as separate trusts; in general.

(a) If a single trust has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries under sections 661 and 662. Application of this rule will be significant in, for example, situations in which income is accumulated for beneficiary A but a distribution is made to beneficiary B of both income and corpus in an amount exceeding the share of income that would be distributable to B had there been separate trusts. In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B. Section 663 (c) does not affect the principles of applicable law in situations in which a single trust instrument creates not one but several separate trusts, as opposed to separate shares in the same trust within the meaning of this section.

(b) The separate share rule does not permit the treatment of separate shares as separate trusts for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts for purposes of:

(1) The filing of returns and payment of tax,

(2) The exclusion of dividends under section 116,

(3) The deduction of personal exemption under section 642 (b), and

(4) The allowance to beneficiaries succeeding to the trust property of excess deductions and unused net operating loss and capital loss carryovers on termination of the trust under section 642 (h).

(c) The separate share rule may be applicable even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust, and even though no physical segregation of assets is made or required.

(d) Separate share treatment is not elective. Thus, if a trust is properly treated as having separate and independent shares, such treatment must prevail in all taxable years of the trust unless an event occurs as a result of which the terms of the trust instrument and the requirements of proper administration require different treatment.

§ 1.663(c)–2 Computation of distributable net income.

The amount of distributable net income for any share under section 663(c) is computed for each share as if each share constituted a separate trust. Accordingly, any deduction or any loss which is applicable solely to one separate share of the trust is not available to any other share of the same trust.

§ 1.663(c)–3 Applicability of separate share rule.

(a) The applicability of the separate share rule provided by section 663(c) will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Thus, if an instrument directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663 (c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a separate share may exist if the instrument provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

(b) Separate share treatment will not be applied to a trust or portion of a trust subject to a power to:

(1) Distribute, apportion, or accumulate income, or

(2) Distribute corpus

to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist.

(c) A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

(d) Separate share treatment may be given to a trust or portion of a trust otherwise qualifying under this section if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for

the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

(e) The separate share rule may also be applicable to successive interests in point of time, as for instance in the case of a trust providing for a life estate to A and a second life estate or outright remainder to B. In such a case, in the taxable year of a trust in which a beneficiary dies items of income and deduction properly allocable under trust accounting principles to the period before a beneficiary's death are attributed to one share, and those allocable to the period after the beneficiary's death are attributed to the other share. Separate share treatment is not available to a succeeding interest, however, with respect to distributions which would otherwise be deemed distributed in a taxable year of the earlier interest under the throwback provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code. The application of this paragraph may be illustrated by the following example:

Example. A trust instrument directs that the income of a trust is to be paid to A for her life. After her death income may be distributed to B or accumulated. A dies on June 1, 1956. The trust keeps its books on the basis of the calendar year. The trust instrument permits invasions of corpus for the benefit of A and B, and an invasion of corpus was in fact made for A's benefit in 1956. In determining the distributable net income of the trust for the purpose of determining the amounts includible in A's income, income and deductions properly allocable to the period before A's death are treated as income and deductions of a separate share, and for that purpose no account is taken of income and deductions allocable to the period after A's death.

(f) Separate share treatment is not applicable to an estate.

§ 1.663(c)–4 Example.

Section 663(c) may be illustrated by the following example:

Example. (a) A single trust was created in 1940 for the benefit of A, B, and C, who were aged 6, 4, and 2, respectively. Under the terms of the instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income is to be accumulated until he becomes 21 years of age. When a beneficiary reaches the age of 21, his share of the income may thereafter be either accumulated or distributed to him in the discretion of the trustee. The trustee also has discretion to invade corpus for the benefit of any beneficiary to the extent of his share of the trust estate, and the trust instrument requires that the beneficiary's right to future income and corpus will be proportionately reduced. When each beneficiary reaches 35 years of age, his share of the trust estate shall be paid over to him. The interest in the trust estate of any beneficiary dying without issue and before he has attained the age of 35 is to be equally divided between the other beneficiaries of the trust. All expenses of the trust are allocable to income under the terms of the trust instrument.

(b) No distributions of income or corpus were made by the trustee prior to 1955, although A became 21 years of age on June 30, 1954. During the taxable year 1955, the trust has income from royalties of $20,000 and expenses of $5,000. The trustee in his discretion distributes $12,000 to A. Both A and the trust report on the calendar year basis.

(c) The trust qualifies for the separate share treatment under section 663 (c) and the distributable net income must be divided into three parts for the purpose of determining the amount deductible by the trust under section 661 and the amount includible in A's gross income under section 662.

(d) The distributable net income of each share of the trust is $5,000 ($6,667 less $1,667). Since the amount ($12,000) distributed to A during 1955 exceeds the distributable net income of $5,000 allocated to his share, the trust is deemed to have distributed to him $5,000 of 1955 income and $7,000 of amounts other than 1955 income. Accordingly, the trust is allowed a deduction of $5,000 under section 661. The taxable income of the trust for 1955 is $9,900, computed as follows:

Royalties		$20,000
Deductions:		
Expenses	$5,000	
Distribution to A	5,000	
Personal exemption	100	
		10,100
Taxable income		9,900

(e) In accordance with section 662, A must include in his gross income for 1955 an amount equal to the portion ($5,000) of the distributable net income of the trust allocated to his share. Also, the excess distribution of $7,000 made by the trust is subject to the throwback provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, and the regulations thereunder.

TREATMENT OF EXCESS DISTRIBUTIONS BY TRUSTS

§ 1.665(a) Statutory provisions; excess distributions by trusts; definition of undistributed net income.

SEC. 665. *Definitions applicable to subpart D*—(a) *Undistributed net income.* For purposes of this subpart, the term "undistributed net income" for any taxable year means the amount by which distributable net income of the trust for such taxable year exceeds the sum of—

(1) The amounts for such taxable year specified in paragraphs (1) and (2) of section 661 (a); and

(2) The amount of taxes imposed on the trust.

§ 1.665(a)–0 Excess distributions by trusts; scope of subpart D.

Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, is designed generally to prevent a shift of tax burden to a trust from a beneficiary or beneficiaries. To accomplish this, subpart D provides special rules for treatment of amounts paid, credited, or required to be distributed by a complex trust (subject to subpart C (section 661 and following) of such part I) in any year in excess of distributable net income for that year. Such an excess distribution is defined as an accumulation distribution, subject to the limitations in section 665(b). An accumulation distribution is "thrown back" to each of the five preceding years in inverse order. That is, it will be taxed to the beneficiaries of the trust in the year the distribution is made or required, but, in general, only to the extent of the distributable net income of those years which was not in fact distributed. However, the resulting tax will not be greater than the aggregate of the taxes that would have been attributable to the amounts thrown back to previous years had they been included in gross income of the beneficiaries in those years. To prevent double taxation, the beneficiaries receive a credit for any taxes previously paid by the trust which are attributable to the excess thrown back. Subpart D does not apply to any estate.

§ 1.665(a)–1 Undistributed net income.

(a) The term "undistributed net income" means for any taxable year the distributable net income of the trust for that year as determined under section 643 (a), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in paragraphs (1) and (2) of section 661 (a), and

(2) The amount of taxes imposed on the trust, as defined in § 1.665 (c)–1.

The application of the rule in this paragraph to the first year of a trust in which income is accumulated may be illustrated by the following example:

Example. Assume that under the terms of the trust, $10,000 of income is required to be distributed currently to A and the trustee has discretion to make additional distributions to A. During the taxable year 1954 the trust had distributable net income of $30,100 derived from royalties and the trustee made distributions of $20,000 to A. The taxable income of the trust is $10,000 on which a tax of $2,640 is paid. The undistributed net income of the trust as of the close of the taxable year 1954 is $7,460 computed as follows:

Distributable net income		$30,100
Less:		
Income currently distributable to A	$10,000	
Other amounts distributed to A	10,000	
Taxes imposed on the trust (see § 1.665 (c)–1)	2,640	
		22,640
Undistributed net income		7,460

See also paragraphs (e) (1) and (f) (1) of § 1.668 (b)–2 for additional illustrations of the application of the rule in this paragraph to the first year of a trust in which income is accumulated.

(b) However, the undistributed net income for any year to which an accumulation distribution for a later year may be thrown back may be reduced by accumulation distributions in intervening years and also by any taxes imposed on the trust which are deemed to be distributed under section 666 by reason of the accumulation distributions. On the other hand, undistributed net income for any year will not be reduced by any distributions in an intervening year which are excluded from the definition of an accumulation distribution under section 665 (b), or which are excluded under section 663 (a) (1), relating to gifts, bequests, etc. See paragraph (f) (5) of § 1.668 (b)–2 for an illustration of the reduction of undistributed net income for any year by a subsequent accumulation distribution.

§ 1.665(b) Statutory provisions; excess distributions by trusts; definition of accumulation distribution.

SEC. 665. *Definitions applicable to subpart D.* • • •

(b) *Accumulation distribution.* For purposes of this subpart, the term "accumulation distribution" for any taxable year of the trust means the amount (if in excess of $2,000) by which the amounts specified in paragraph (2) of section 661 (a) for such taxable year exceed distributable net income reduced by the amounts specified in paragraph (1) of section 661 (a). For purposes of this subsection, the amount specified in paragraph (2) of section 661 (a) shall be determined without regard to section 666 and shall not include—

(1) Amounts paid, credited, or required to be distributed to a beneficiary as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21;

(2) Amounts properly paid or credited to a beneficiary to meet the emergency needs of such beneficiary;

(3) Amounts properly paid or credited to a beneficiary upon such beneficiary's attaining a specified age or ages if—

(A) The total number of such distributions cannot exceed 4 with respect to such beneficiary,

(B) The period between each such distribution to such beneficiary is 4 years or more, and

(C) As of January 1, 1954, such distributions are required by the specific terms of the governing instrument; and

(4) Amounts properly paid or credited to a beneficiary as a final distribution of the trust if such final distribution is made more than 9 years after the date of the last transfer to such trust.

§ 1.665(b)–1 Accumulation distribution; in general.

(a) Subject to the limitations set forth in § 1.665(b)–2, the term "accumulation distribution" for any taxable year means an amount (if in excess of $2,000) by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) for that year exceed the distributable net income (determined under section 643(a) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. (In computing the amount of an accumulation distribution pursuant to the preceding sentence, there is taken into account amounts applied or distributed for the support of a dependent under the circumstances specified in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year and amounts used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4.) If the distribution as so computed is $2,000 or less, it is not an accumulation distribution within the meaning of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code. If the distribution exceeds $2,000, then the full amount is an accumulation distribution for the purposes of subpart D.

(b) Although amounts properly paid, credited, or required to be distributed under section 661 (a) (2) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if such amounts exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently. This may result from the fact that expenses allocable to corpus are taken into account in determining taxable income and hence distributable net income. However, the provisions of subpart D will not apply unless there is undistributed net income in at least one of the five preceding taxable years. See section 666 and the regulations thereunder.

(c) The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples (it is assumed in each case that the exclusions provided in § 1.665 (b)–2 do not apply):

Example (1). A trustee properly makes a distribution to a beneficiary of $20,000 during the taxable year 1956, of which $10,000 is income required to be distributed currently to the beneficiary. The distributable net income of the trust is $15,000. There is an accumulation distribution of $5,000 computed as follows:

Total distribution	$20,000
Less: Income required to be distributed currently (section 661 (a) (1))	10,000
Other amounts distributed (section 661 (a) (2))	10,000
Distributable net income	$15,000
Less: Income required to be distributed currently	10,000
Balance of distributable net income	5,000
Accumulation distribution	5,000

Example (2). Under the terms of the trust instrument, an annuity of $15,000 is required to be paid to A out of income each year and the trustee may in his discretion make distributions out of income or corpus to B. During the taxable year the trust had income of $18,000, as defined in section 643 (b), and expenses allocable to corpus of $5,000. Distributable net income amounted to $13,000. The trustee distributed $15,000 of income to A and, in the exercise of his discretion, paid $5,000 to B. There is an accumulation distribution of $5,000 computed as follows:

Total distribution	$20,000
Less: Income required to be distributed currently to A (section 661 (a) (1))	15,000
Other amounts distributed (section 661 (a) (2))	5,000
Distributable net income	$13,000
Less: Income required to be distributed currently to A	15,000
Balance of distributable net income	0
Accumulation distribution to B	5,000

Example (3). Under the terms of a trust instrument, the trustee may either accumulate the trust income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. During the taxable year, the trust had income as defined in section 643 (b) of $22,000 and expenses of $5,000 allocable to corpus. Distributable net income amounts to $17,000. The trustee distributed $10,000 each to A and B during the taxable year. There is an accumulation distribution of $3,000 computed as follows:

Total distribution	$20,000
Less: Income required to be distributed currently	0
Other amounts distributed (section 661 (a) (2))	20,000
Distributable net income	17,000
Accumulation distribution	3,000

(d) There are not taken into account, in computing the accumulation distribution for any taxable year, any amounts deemed distributed in that year because of an accumulation distribution in a later year.

§ 1.665(b)–2 Exclusions from accumulation distributions.

(a) Certain amounts paid, credited, or required to be distributed to a beneficiary are excluded under section 665(b) in determining whether there is an accumulation distribution for the purposes of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code. These exclusions are solely for the purpose of determining the amount allocable to preceding years under section 666 and in no way affect the determination under subpart C (section 661 and following) of such part I of the beneficiary's tax liability for the year of distribution. Further, amounts excluded from accumulation distributions do not reduce the amount of undistributed net income for the 5 years preceding the year of distribution.

(b) The amounts excluded from the computation of an accumulation distribution are discussed in the following subparagraphs:

(1) *Distributions from accumulations while a beneficiary is under 21.* (i) The first exception to the definition of an accumulation distribution is for amounts paid, credited, or required to be distributed to a beneficiary who was under 21 years of age or unborn when it was accumulated. A distribution is to be considered as so paid, credited, or required to be distributed to the extent, and only to the extent, that there is no undistributed net income for taxable years preceding the year of distribution other than undistributed net income accumulated while the beneficiary was under 21. If a distribution can be made from income accumulated either before or after a beneficiary reaches 21, it will be considered as made from the most recently accumulated income, and it will be so considered even though the governing instrument directs that distributions be charged first against the earliest accumulations.

(ii) As was indicated in paragraph (a) of this section, a distribution of an amount excepted from the definition of an accumulation distribution will not reduce undistributed net income for the purpose of determining the effect of a future accumulation distribution. Thus, a distribution to a beneficiary of income accumulated before he reached 21 would not reduce the undistributed net income includible in a future accumulation distribution to another beneficiary. However, all future distributions to the same beneficiary, or to another beneficiary to whom a distribution would be excepted under the provisions of this subparagraph, would be excepted from the definition of an accumulation distribution to the extent that they could not be paid, credited, or required to be distributed from other accumulated income.

(iii) The following examples illustrate the application of the foregoing rules of this subparagraph (in each of these examples it is assumed that the exceptions in section 665 (b) (2), (3), and (4) do not apply):

(a) Income is to be accumulated until A reaches 21 when the corpus and accumulated income are to be distributed to him. The distribution is not an accumulation distribution.

(b) Income is to be accumulated until A is 21, when it is to be distributed to him but the corpus is to remain in trust. A distribution of the accumulated income to A when he reaches 21 is not an accumulation distribution.

(c) Income is to be accumulated and added to corpus until A reaches 21, when he is to receive one-third of the corpus (including accumulations). Thereafter all the income is to be paid to A until he is 23 when the remaining corpus (including accumulations) is to be paid to him. If A dies under that age any undistributed portion is to be paid to B. Distributions to A at 21 and 23 out of accumulations are not accumulation distributions even though they include accumulated income. However, if A died at the age of 22, when B was 23, a distribution to B would be an accumulation distribution to the extent of income accumulations since B reached 21, and the amount of undistributed net income includible in the distribution will not be reduced by the previous distribution to A.

(d) Income is to be accumulated and added to corpus until A is 21. After he is 21, he is entitled to all the income and, in addition, to distributions of corpus in the discretion of the trustee. When he reaches 25 he is entitled to the corpus. Distributions to A are not accumulation distributions, whether they are discretionary or upon termination of the trust.

(e) The facts are the same as in the preceding example, except that income is to be accumulated until A is 23. Distributions to A are accumulation distributions to the extent of income accumulated after A reached 21.

(f) Income may be distributed among a testator's children or accumulated and added to corpus until the youngest child is 21, when the corpus is to be distributed to the testator's then living descendants. Upon termination of the trust, the corpus is distributed to A, age 21; B, age 23; and C, the child of a deceased child, age 3. The distributions to A and C are not accumulation distributions. The distribution to B is an accumulation distribution to the extent of income accumulated after he reaches 21. (If the terms of the trust were such that it was subject to the separate share treatment under section 663 (c), the distribution to B would be an accumulation distribution only to the extent of income accumulated for B's separate share since he reached 21.)

(g) Income may be distributed to A or accumulated and added to corpus during A's life. Upon the death of A the corpus is to be distributed to B. B is 23 at A's death. The distribution is an accumulation distribution to the extent of income accumulated since B reached 21.

(2) *Emergency distributions.* The second exclusion from the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary to meet his emergency needs. Whether or not a distribution falls within this exclusion depends upon the facts and circumstances causing the distribution. A distribution based upon an unforeseen or unforeseeable combination of circumstances requiring immediate help to the beneficiary would qualify for the exclusion. However, the beneficiary must be in actual need of the distribution and the fact that he had other sufficient resources would tend to negate the conclusion that a distribution was to meet his emergency needs. Ordinary distributions for the support, maintenance, or education of the beneficiary would not qualify for the exclusion.

(3) *Certain distributions at specified ages.* The third exclusion from the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary upon the beneficiary's attaining a specified age or ages; provided, (i) the total number of such distributions with respect to that beneficiary cannot exceed 4; (ii) the period between each such distribution is 4 years or more; and (iii) on January 1, 1954, such distributions were required by the specific terms of the governing instrument. Any discretionary invasion of corpus at other times is not excluded under this subparagraph, but does not affect the status of distributions that would otherwise be excluded. If more than four distributions are required to be made to a particular beneficiary at specified ages if he survives to receive them, none of the distributions will be excluded, even though the beneficiary dies before he receives more than four. On the other hand, a direction to make additional distributions to a remainderman will not affect the status of distributions required to be made to the primary beneficiary. For example, a trust agreement provided on January 1, 1954, that when A reached age 25 he would receive one-eighth of the corpus and accumulated income, as then constituted, and similar distributions at ages 30, 35, and 40. It also provided for similar distributions to B after A's death, and for additional discretionary distributions to both A and B. Required distributions to both A and B are excluded, regardless of whether discretionary distributions are made, but discretionary distributions are not excluded. On the other hand, if an additional distribution to A was directed when he reached 45, no distributions to him would be excluded, regardless of when he died.

(4) *Certain final distributions.* (i) The last exception to the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary as a final distribution of a trust if the final distribution is made more than 9 years after the date of the last transfer to such trust.

(ii) The term "last transfer to such trust" includes only transfers, whether by the original grantor or by a third person, made with a donative intent. A transfer arising out of a property right held by the trust is excluded, such as a transfer by a debtor in satisfaction of his indebtedness, or a distribution in liquidation or reorganization of a corporation. If the terms of two or more trusts include cross-remainders on the deaths of life beneficiaries, the donative transfers occurred at the time the trusts were created. The addition of the corpus of one trust to that of another when a remainder falls in is therefore not a new transfer within the meaning of section 665 (b) (4).

(iii) For example, under the terms of a trust created July 1, 1950, with an original corpus of $100,000, by H for the benefit of his wife, W, the income of the trust is to be accumulated and added to corpus. Upon the expiration of a 10-year period, the trust is to terminate and its assets, including all accumulated income, are to be distributed to W. No transfers were made by H or other persons to the trust after it was created. Both the trust and W file returns on the calendar year basis. In accordance with its terms, the trust terminated on June 30, 1960, and on August 1, 1960, the trustee made a final distribution of the assets of the trust to W, consisting of investments derived from $100,000 of donated principal, accumulated income of $30,000 attributable to the period July 1, 1950, through December 31, 1959, and income of $3,000 attributable to the period the trust was in existence during 1960. Subpart D is inapplicable to the $3,000 of income of the trust for 1960 since that amount would be deductible by the trust and includible in W's gross income for that year to the extent provided in subpart C. However, the balance of the distribution will qualify as an exclusion from the provisions of subpart D.

§ 1.665(b)–3 Exclusions under section 663(a)(1).

Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, has no application to an amount which qualifies as an exclusion under section 663 (a) (1), relating to gifts, bequests, etc.

§ 1.665(c) Statutory provisions; excess distributions by trusts; definition of taxes imposed on the trust.

SEC. 665. *Definitions applicable to subpart D.* • • •

(c) *Taxes imposed on the trust.* For purposes of this subpart, the term "taxes imposed on the trust" means the amount of the taxes which are imposed for any taxable year on the trust under this chapter (without regard to this subpart) and which, under regulations prescribed by the Secretary or his delegate, are properly allocable to the undistributed portion of the distributable net income. The amount determined in the preceding sentence shall be reduced by any amount of such taxes allowed, under sections 667 and 668, as a credit to any beneficiary on account of any accumulation distribution determined for any taxable year.

§ 1.665(c)–1 Taxes imposed on the trust.

(a) For the purpose of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, the term "taxes imposed on the trust" means (for any taxable year) the amount of Federal income taxes which are properly allocable to the undistributed portion of the distributable net income. This amount is the difference between the total taxes of the trust for the year and the amount which would have been paid

by the trust had all of the distributable net income, as determined under section 643(a), been distributed. Thus, in determining the amount of taxes imposed on the trust for the purposes of subpart D, there is excluded the portion of the taxes paid by the trust which is attributable to items of gross income which are not includible in distributable net income, such as capital gains allocable to corpus. The rule stated in this paragraph may be illustrated by the following example:

Example. (1) Under the terms of a trust, which reports on the calendar year basis, the income may be accumulated or distributed to A in the discretion of the trustee and capital gains are allocable to corpus. During the taxable year 1954, the trust had income of $20,000 from royalties, long-term capital gains of $10,000, and expenses of $2,000. The trustee in his discretion made a distribution of $10,000 to A. The taxes imposed on the trust for the purposes of this subpart are $2,713, determined as shown below.

(2) The distributable net income of the trust computed under section 643 (a) is $18,000 (royalties of $20,000 less expenses of $2,000). The total taxes paid by the trust are $3,787, computed as follows:

Royalties		$20,000
Capital gains		10,000
Gross income		30,000
Deductions:		
Expenses	$2,000	
Distributions to A	10,000	
Capital gain deduction	5,000	
Personal exemption	100	
		17,100
Taxable income		12,900
Total income taxes		3,787

(3) The amount of taxes which would have been paid by the trust, had all of the distributable net income ($18,000) of the trust been distributed to A, is $1,074, computed as follows:

Taxable income of the trust	$12,900
Less: Undistributed portion of distributable net income ($18,000 −$10,000)	8,000
Balance of taxable income	4,900
Income taxes on $4,900	1,074

(4) The amount of taxes imposed on the trust as defined in this paragraph is $2,713, computed as follows:

Total taxes	$3,787
Taxes which would have been paid by the trust had all of the distributable net income been distributed	1,074
Taxes imposed on the trust as defined in this paragraph	2,713

(b) If in any subsequent year an accumulation distribution is made by the trust which results in a throwback to the taxable year, the taxes of the taxable year allocable to the undistributed portion of distributable net income (the taxes imposed on the trust), after the close of the subsequent year, are the taxes prescribed in paragraph (a) of this section reduced by the taxes of the taxable year allowed as credits to beneficiaries on account of amounts deemed distributed on the last day of the taxable year under section 666. See paragraph (f) (4) of § 1.668 (b)–2 for an illustration of the application of this paragraph.

§ 1.665(d) Statutory provisions; excess distributions by trusts; definition of preceding taxable year.

SEC. 665. *Definitions applicable to subpart D.* * * *

(d) *Preceding taxable year.* For purposes of this subpart, the term "preceding taxable year" does not include any taxable year of the trust to which this part does not apply. In the case of a preceding taxable year with respect to which a trust qualifies (without regard to this subpart) under the provisions of subpart B, for purposes of the application of this subpart to such trust for such taxable year, such trust shall, in accordance with regulations prescribed by the Secretary or his delegate, be treated as a trust to which subpart C applies.

§ 1.665(d)–1 Preceding taxable year.

(a) *Definition.* For purposes of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code of 1954, the term "preceding taxable year" does not include any taxable year to which such part I does not apply. See section 683 and regulations thereunder. Accordingly, the provisions of such subpart D may not, in general, be applied to any taxable year which begins before 1954 or ends before August 17, 1954. For example, if a trust (reporting on the calendar year basis) makes a distribution during the calendar year 1955 of income accumulated during prior years and the distribution exceeds the distributable net income of 1955, the excess distribution may be allocated under such subpart D to 1954, but it may not be allocated to 1953 and preceding years, since the Internal Revenue Code of 1939 applies to those years.

(b) *Simple trusts subject to subpart D.* An accumulation distribution may be properly allocated to a preceding taxable year in which the trust qualified as a simple trust (that is, qualified for treatment under subpart B (section 651 and following) of such part I. In such event, the trust is treated for such preceding taxable year in all respects as if it were a trust to which subpart C (section 661 and following) of such part I applies. An example of such a circumstance would be in the case of a trust (required under the trust instrument to distribute all of its income currently) which received in the preceding taxable year extraordinary dividends or taxable stock dividends which the trustee in good faith allocated to corpus, but which are subsequently determined to be currently distributable to the beneficiary. See section 643(a)(4) and § 1.643(a)–4. The trust would qualify for treatment under such subpart C for the year of distribution of the extraordinary dividends or taxable stock dividends, because the distribution is not out of income of the current taxable year and would be treated as other amounts properly paid or credited or required to be distributed for such taxable year within the meaning of section 661 (a) (2). Also, the distribution would qualify as an accumulation distribution for the purposes of such subpart D if in excess of $2,000 and not excepted under section 665(b) and the regulations thereunder. For the purposes only of such subpart D, the trust would be treated as subject to the provisions of such subpart C for the preceding taxable year in which the extraordinary or taxable stock dividends were received, and, in computing undistributed net income for such preceding year, the extraordinary or taxable stock dividends would be included in distributable net income under section 643 (a). The rule stated in the preceding sentence would also apply if the distribution in the later year were made out of corpus without regard to a determination that the extraordinary dividends or taxable stock dividends in question were currently distributable to the beneficiary.

§ 1.665(d)–2 Application of separate share rule.

In trusts to which the separate share rule of section 663(c) is applicable for any taxable year, subpart D (section 665 and following), part I, subchapter J, of the Code, is applied as if each share were a separate trust. Thus, "undistributed net income" and the amount of an "accumulation distribution" are computed separately for each share. The "taxes imposed on the trust" are allocated as follows:

(a) There is first allocated to each separate share that portion of the "taxes imposed on the trust", computed before the allowance of credits under section 642 (a), which bears the same relation to the total that the distributable net income of the separate share bears to the distributable net income of the trust, adjusted for this purpose as follows:

(1) There is excluded from distributable net income of the trust and of each separate share any tax-exempt interest, foreign income of a foreign trust, and excluded dividends, to the extent such amounts are included in distributable net income pursuant to section 643 (a) (5), (6), and (7); and

(2) The distributable net income of the trust is reduced by any deductions allowable under section 661 for amounts paid, credited, or required to be distributed during the taxable year, and the distributable net income of each separate share is reduced by any such deduction allocable to that share.

(b) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642 (a) in computing the "taxes imposed on the trust" which bear the same relation to the total that the items of income allocable to the separate share with respect to which the credit is allowed bear to the total of such items of the trust. The amount of taxes imposed on the trust allocable to a separate share as so determined is then reduced by the amount of the taxes allowed under sections 667 and 668 as a credit to a beneficiary of the separate share on account of any accumulation distribution determined for any taxable year intervening between the year for which the determination is made and the year of an accumulation distribution with respect to which the determination is made. See paragraph (b) of § 1.665 (c)–1.

§ 1.666(a) Statutory provisions; excess distributions by trusts; allocation of accumulation distribution.

SEC. 666. *Accumulation distribution allocated to 5 preceding years—(a) Amount allocated.* In the case of a trust which for a

taxable year beginning after December 31, 1953, is subject to subpart C, the amount of the accumulation distribution of such trust for such taxable year shall be deemed to be an amount within the meaning of paragraph (2) of section 661 (a) distributed on the last day of each of the 5 preceding taxable years to the extent that such amount exceeds the total of any undistributed net incomes for any taxable years intervening between the taxable year with respect to which the accumulation distribution is determined and such preceding taxable year. The amount deemed to be distributed in any such preceding taxable year under the preceding sentence shall not exceed the undistributed net income of such preceding taxable year. For purposes of this subsection, undistributed net income for each of such 5 preceding taxable years shall be computed without regard to such accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

§ 1.666(a)–1 Amount allocated.

(a) If a trust makes an accumulation distribution in any taxable year, the distribution is included in the beneficiary's taxable income for that year to the extent of the undistributed net income of the trust for the preceding 5 years. It is therefore necessary to determine the extent to which there is undistributed net income for the preceding 5 years. For this purpose, an accumulation distribution made in any taxable year is allocated to each of the 5 preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income of each of those years. Thus, an accumulation distribution is deemed to have been made from the most recently accumulated income of the trust.

(b) If, before the application of the provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, to an accumulation distribution for the taxable year, there is no undistributed net income for a preceding taxable year, then no portion of the accumulation distribution is deemed distributed on the last day of such preceding taxable year. Thus, if an accumulation distribution is made during the taxable year 1960 and the trust had no undistributed net income for the taxable year 1959, then no portion of the 1960 accumulation distribution is deemed distributed on the last day of 1959. For purposes of subpart D, the term "5 preceding taxable years" includes only the 5 taxable years immediately preceding the taxable year in which the accumulation distribution is made and which are subject to part I (section 641 and following) of such subchapter J even though the trust has no undistributed net income during one or more of those years.

(c) Paragraphs (a) and (b) of this section may be illustrated by the following example:

Example. In 1959, a trust, reporting on the calendar year basis, makes an accumulation distribution of $25,000. In 1958, the trust had $7,000 of undistributed net income; in 1957, none; in 1956, $12,000; in 1955, $4,000; in 1954, $4,000. The accumulation distribution will be deemed distributed $7,000 in 1958, none in 1957, $12,000 in 1956, $4,000 in 1955, and $2,000 in 1954.

(d) For the purposes of allocating to any preceding taxable year an accumulation distribution of the taxable year, the undistributed net income of such preceding taxable year is computed without regard to the accumulation distribution of the taxable year or of taxable years following the taxable year. However, accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year are taken into account. Accordingly, if a trust has undistributed net income for the taxable year 1954 and makes an accumulation distribution during the taxable year 1955, the undistributed net income for 1954 is computed without regard to the accumulation distribution for 1955 or any subsequent year. If the trust makes a further accumulation distribution for 1956, the undistributed net income for 1954 is computed without regard to the accumulation distribution for 1956 or subsequent years; but in determining the undistributed net income for 1954 for purposes of the 1956 accumulation distribution the accumulation distribution for 1955 will be taken into account.

§ 1.666(b) Statutory provisions; excess distributions by trusts; total taxes deemed distributed.

SEC. 666. *Accumulation distribution allocated to 5 preceding years.* * * *

(b) *Total taxes deemed distributed.* If any portion of an accumulation distribution for any taxable year is deemed under subsection (a) to be an amount within the meaning of paragraph (2) of section 661 (a) distributed on the last day of any preceding taxable year, and such portion of such accumulation distribution is not less than the undistributed net income for such preceding taxable year, the trust shall be deemed to have distributed on the last day of such preceding taxable year an additional amount within the meaning of paragraph (2) of section 661 (a). Such additional amount shall be equal to the taxes imposed on the trust for such preceding taxable year. For purposes of this subsection, the undistributed net income and the taxes imposed on the trust for such preceding taxable year shall be computed without regard to such accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

§ 1.666(b)–1 Total taxes deemed distributed.

(a) If an accumulation distribution is deemed under § 1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the "taxes imposed on the trust" (as defined in § 1.665(c)–1) for such preceding taxable year is likewise deemed distributed under section 661(a)(2). For example, a trust has taxable income of $11,032 (not including any capital gains) and undistributed net income of $8,000 for the taxable year 1954. The taxes imposed on the trust are $3,032. During the taxable year 1955, an accumulation distribution of $8,000 is made to the beneficiary, which is deemed under § 1.666 (a)–1 to have been distributed on the last day of 1954. The taxes imposed on the trust for 1954 of $3,032 are also deemed to have been distributed on the last day of 1954 since the 1955 accumulation distribution is not less than the 1954 undistributed net income. Thus, a total of $11,032 will be deemed to have been distributed on the last day of 1954 because of the accumulation distribution of $8,000 made in 1955.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year is computed without regard to the accumulation distribution of the taxable year or any taxable year following such taxable year. However, any accumulation distribution of taxable years intervening between such preceding taxable year and the taxable year are taken into account. See paragraph (d) of § 1.666 (a)–1 and paragraphs (f) (5) and (g) (1) of § 1.668 (b)–2.

§ 1.666(c) Statutory provisions; excess distributions by trusts; pro rata portion of taxes deemed distributed.

SEC. 666. *Accumulation distribution allocated to 5 preceding years.* * * *

(c) *Pro rata portion of taxes deemed distributed.* If any portion of an accumulation distribution for any taxable year is deemed under subsection (a) to be an amount within the meaning of paragraph (2) of section 661 (a) distributed on the last day of any preceding taxable year and such portion of the accumulation distribution is less than the undistributed net income for such preceding taxable year, the trust shall be deemed to have distributed on the last day of such preceding taxable year an additional amount within the meaning of paragraph (2) of section 661 (a). Such additional amount shall be equal to the taxes imposed on the trust for such taxable year multiplied by the ratio of the portion of the accumulation distribution to the undistributed net income of the trust for such year. For purposes of this subsection, the undistributed net income and the taxes imposed on the trust for such preceding taxable year shall be computed without regard to the accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

§ 1.666(c)–1 Pro rata portion of taxes deemed distributed.

(a) If an accumulation distribution is deemed under § 1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount is likewise deemed distributed under section 661(a)(2). The additional amount is equal to the taxes imposed on the trust, as defined in § 1.665(c)–1, for such preceding taxable year, multiplied by the fraction of which the numerator is the amount of the accumulation distribution and the denominator is the undistributed net income for such preceding taxable year. See paragraph (b) of example (1) and paragraphs (c) and (f) of example (2) in § 1.666(c)–2, and paragraph (f)(2) of § 1.668(b)–2 for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year is computed without regard to the accumulation distribution of the taxable year or any taxable year following the taxable year. However, accumulation distributions of any taxable years intervening

between such preceding taxable year and the taxable year are taken into account. See paragraph (d) of § 1.666 (a)–1, paragraph (c) of example (1) and paragraphs (e) and (h) of example (2) in § 1.666 (c)–2 and paragraph (f) (5) (iii) of § 1.668 (b)–2.

§ 1.666(c)–2 Illustration of the provisions of section 666.

The application of the provisions of §§ 1.666(a)–1, 1.666(b)–1, and 1.666(c)–1 may be illustrated by the following examples:

Example (1). (a) A trust makes accumulation distributions as follows:

1959	$7,000
1960	25,000

For 1954 through 1958, the undistributed portion of distributable net income, taxes imposed on the trust, and undistributed net income are as follows:

Year	Undistributed portion of distributable net income	Taxes imposed on the trust	Undistributed net income
1958	$12,100	$3,400	$8,700
1957	16,100	5,200	10,900
1956	6,100	1,360	4,740
1955	None	None	None
1954	10,100	2,640	7,460

(b) Since the entire amount of the accumulation distribution for 1959 ($7,000), determined without regard to the accumulation distribution for 1960, is less than the undistributed net income for 1958 ($8,700), an additional amount of $2,736 (7,000/8,700×$3,400) is likewise deemed distributed under section 666 (c).

(c) In allocating the accumulation distribution for 1960, the undistributed net income for 1958 will take into account the accumulation distribution for 1959, and the additional amount of taxes imposed on the trust for 1958 deemed distributed. The undistributed net income for 1958 will then be $1,906; and the taxes imposed on the trust for 1958 will then be $458, determined as follows:

Undistributed portion of distributable net income as of the close of 1958		$12,100
Less:		
Accumulation distribution (1959)	$7,000	
Taxes deemed distributed under section 666 (c) (7,000/8,700×$3,400)	2,736	9,736
Balance (undistributed portion of distributable net income as of the close of 1959)		2,364
Less: Personal exemption		$100
Balance		2,264
Taxes imposed on the trust (income taxes on $2,264)		$458
Undistributed portion of distributable net income as of the close of 1959		2,364
Less: Income taxes attributable thereto		458
Undistributed net income for 1958 as of the close of 1959		1,906

(d) The accumulation distribution of $25,000 for 1960 is deemed to have been made on the last day of the 5 preceding taxable years of the trust to the extent of $17,546, the total of the undistributed net income for such years, as shown in the tabulation below. In addition, $7,018, the total taxes imposed on the trust for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed net income	Taxes imposed on the trust
1959	None	None
1958	$1,906	$458
1957	10,900	5,200
1956	4,740	1,360
1955	None	None

(e) No portion of the 1960 accumulation distribution is deemed made on the last day of 1954 because, as to 1960, 1954 is the sixth preceding taxable year.

Example (2). (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The entire income of the trust is from royalties. Both X and the trust report on the calendar year basis. All of the income for 1954 was accumulated. The distributable net income of the trust for the taxable year 1954 is $20,100 and the income taxes paid by the trust for 1954 with respect to its distributable net income are $7,260. All of the income for 1955 and 1956 was distributed and in addition the trustee made accumulation distributions within the meaning of section 665 (b) of $6,420 for each year.

(b) The undistributed net income of the trust determined under section 665 (a) as of the close of 1954, is $12,840, computed as follows:

Distributable net income		$20,100
Less: Taxes imposed on the trust		7,260
Undistributed net income as of the close of 1954		12,840

(c) The accumulation distribution of $6,420 made during the taxable year 1955 is deemed under section 666 (a) to have been made on December 31, 1954. Since this accumulation distribution is less than the 1954 undistributed net income of $12,840, a portion of the taxes imposed on the trust for 1954 is also deemed under section 666 (c) to have been distributed on December 31, 1954. The total amount deemed to have been distributed to X on December 31, 1954, is $10,050, computed as follows:

Accumulation distribution		$6,420
Taxes deemed distributed (6,420/12,840×$7,260)		3,630
Total		10,050

(d) After the application of the provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, to the accumulation distribution of 1955, the undistributed portion of the distributable net income of the trust for 1954, is $10,050, and the taxes imposed with respect thereto are $2,623, computed as follows:

Distributable net income as of the close of 1954		$20,100
Less: 1955 accumulation distribution and taxes deemed distributed on December 31, 1954 (paragraph (c) of this example)		10,050
Undistributed portion of the 1954 distributable net income adjusted as of the close of 1955		10,050
Less: Personal exemption		100
Balance		9,950
Income taxes on $9,950		2,623

(e) The undistributed net income of the trust for the taxable year 1954, as adjusted to give effect to the 1955 accumulation distribution, is $7,427, computed as follows:

Undistributed portion of distributable net income as of the close of 1955		$10,050
Less: Income taxes applicable thereto		2,623
Undistributed net income determined as of the close of 1955		7,427

(f) Inasmuch as all of the income of the trust for the taxable year 1955 was distributed to X, the trust had no undistributed net income for that year. Accordingly, the accumulation distribution of $6,420 made during the taxable year 1956 is, under section 666 (a), deemed a distribution to X on December 31, 1954, within the meaning of section 661 (a) (2). Since this accumulation distribution is less than the 1954 adjusted undistributed net income of $7,427, the trust is deemed under section 666 (c) also to have distributed on December 31, 1954, a portion of the taxes imposed on the trust for 1954. The total amount deemed to be distributed on December 31, 1954, with respect to the accumulation distribution made in 1956, is $8,687, computed as follows:

Accumulation distribution		$6,420
Taxes deemed distributed (6,420/7,427×$2,623)		2,267
Total		8,687

(g) After the application of the provisions of subpart D to the accumulation distribution of 1956, the undistributed portion of the distributable net income of the trust for 1954, is $1,363, and the taxes imposed on the trust with respect thereto are $253, computed as follows:

Undistributed portion of distributable net income as of the close of 1955		$10,050
Less: 1956 accumulation distribution and taxes deemed distributed on December 31, 1954 (paragraph (f) of this example)		8,687
Undistributed portion of distributable net income as of the close of 1956		1,363
Less: Personal exemption		100
Balance		1,263
Income taxes on $1,263		253

(h) The undistributed net income of the trust for the taxable year 1954, determined as of the close of the taxable year 1956, is $1,110 ($1,363 less $253).

§ 1.667 Statutory provisions; excess distributions by trusts; denial of refund to trusts.

SEC. 667. *Denial of refund to trusts.* The amount of taxes imposed on the trust under this chapter, which would not have been payable by the trust for any preceding taxable year had the trust in fact made distributions at the times and in the amounts deemed under section 666, shall not be refunded or credited to the trust, but shall be allowed as a credit under section 668 (b) against the tax of the beneficiaries who are treated as having received the distributions. For purposes of the preceding sentence, the amount of taxes which may not be refunded or credited to the trust shall be an amount equal to the excess of (1) the taxes imposed on the trust for any preceding taxable year (computed without regard to the accumulation distribution for the taxable year) over (2) the amount of taxes for such preceding taxable year imposed on the undistributed portion of distributable net income of the trust for such preceding taxable year after the application of this subpart on account of the accumulation distribution determined for such taxable year.

§ 1.667–1 Denial of refund to trusts.

(a) If an amount is deemed under section 666 to be an amount paid, credited,

or required to be distributed on the last day of a preceding taxable year, the trust is not allowed a refund or credit of the amount of "taxes imposed on the trust", as defined in § 1.665 (c)–1, which would not have been payable for the preceding taxable year had the trust in fact made such distribution on the last day of such year. However, such taxes are allowed as a credit under section 668 (b) against the tax of the beneficiaries who are treated as having received the distributions in the preceding taxable year. The amount of taxes which may not be refunded or credited to the trust under this paragraph and which are allowed as a credit under section 668 (b) against the tax of the beneficiaries, is an amount equal to the excess of:

(1) The taxes imposed on the trust (as defined in section 665 (c) and § 1.665 (c)–1) for any preceding taxable year (computed without regard to the accumulation distribution for the taxable year)

over

(2) The amount of taxes for such preceding taxable year which would be imposed on the undistributed portion of distributable net income of the trust for such preceding taxable year after the application of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, on account of the accumulation distribution determined for the taxable year.

It should be noted that the credit under section 667 is computed by the use of a different ratio from that used for computing the amount of taxes deemed distributed under section 666 (c).

(b) Paragraph (a) of this section may be illustrated by the following examples:

Example (1). In 1954, a trust of which A is the sole beneficiary has taxable income of $20,000 (including capital gains of $5,100 allocable to corpus less a personal exemption of $100), on which a tax of $7,260 is paid. The undistributed portion of distributable net income is $15,000, to which $6,160 of the tax is allocable under section 665. The undistributed net income is therefore $8,840 ($15,000 minus $6,160). In 1955, the trust makes an accumulation distribution of $8,840. Under section 666 (b), the total taxes for 1954 attributable to the undistributed net income are deemed distributed, so $15,000 is deemed distributed. The amount of the tax which may not be refunded to the trust under section 667 and the credit to which A is entitled under section 668 (b) is the excess of $6,160 over zero, since after the distribution and the application of subpart D there is no remaining undistributed portion of distributable net income for 1954.

Example (2). The same trust as in example (1) of this paragraph distributes $5,000 in 1955, rather than $8,840. The amount of the tax which may not be refunded to the trust but which is available to A as a credit is $4,044, computed as follows:

Accumulation distribution in 1955	$5,000
Taxes deemed distributed under section 666 (c) (5,000/8,840×$6,160)	3,484
Total amount deemed distributed out of the undistributed portion of distributable net income	8,484
Tax attributable to the undistributed portion of distributable net income ($15,000) before 1955 distribution (see example (1) of this paragraph)	6,160
Tax on $11,516 (taxable income of $20,000 minus $8,484, amount deemed distributed)	$3,216
Tax on $5,000 (capital gains of $5,100, less personal exemption of $100, allocable to corpus)	1,100
Tax attributable to undistributed portion of distributable net income after 1955 distribution	2,116
Refund disallowed to the trust and credit available to A in 1955	4,044

§ 1.668(a) Statutory provisions; excess distributions by trusts; treatment of amounts deemed distributed in preceding taxable years; amounts treated as received in prior taxable years.

SEC. 668. *Treatment of amounts deemed distributed in preceding years*—(a) *Amounts treated as received in prior taxable years.* The total of the amounts which are treated under section 666 as having been distributed by the trust in a preceding taxable year shall be included in the income of a beneficiary or beneficiaries of the trust when paid, credited, or required to be distributed to the extent that such total would have been included in the income of such beneficiary or beneficiaries under section 662 (a) (2) and (b) if such total had been paid to such beneficiary or beneficiaries on the last day of such preceding taxable year. The portion of such total included under the preceding sentence in the income of any beneficiary shall be based upon the same ratio as determined under the second sentence of section 662 (a) (2) for the taxable year in respect of which the accumulation distribution is determined, except that proper adjustment of such ratio shall be made, in accordance with regulations prescribed by the Secretary or his delegate, for amounts which fall within paragraphs (1) through (4) of section 665 (b). The tax of the beneficiaries attributable to the amounts treated as having been received on the last day of such preceding taxable year of the trust shall not be greater than the aggregate of the taxes attributable to those amounts had they been included in the gross income of the beneficiaries on such day in accordance with section 662 (a) (2) and (b).

§ 1.668(a)–1 Amounts treated as received in prior taxable years; inclusion in gross income.

(a) Section 668(a) provides that the total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust shall be included in the gross income of the beneficiary or beneficiaries receiving them. The total of such amounts is includible in the gross income of each beneficiary to the extent the amounts would have been included under section 662(a)(2) and (b) if the total had actually been paid by the trust on the last day of such preceding taxable year. The total is included in the gross income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662 (c) and the regulations thereunder). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules set forth in section 662 (b) and the regulations thereunder. See paragraphs (h) (1) (ii) and (j) (1) (ii) of § 1.668 (b)–2.

(b) The total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust are included as prescribed in paragraph (a) of this section in the gross income of the beneficiary even though as of that day the beneficiary would not have been entitled to receive them had they actually been distributed on that day.

(c) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of amounts included in a beneficiary's gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary's income.

§ 1.668(a)–2 Allocation among beneficiaries; in general.

The portion of the total amount includible in gross income under § 1.668 (a)–1 which is includible in the gross income of a particular beneficiary is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year (and not for the preceding taxable year). This section may be illustrated by the following example:

Example. (a) Under the terms of a trust instrument, the trustee may accumulate the income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. The distributable net income of the trust for the taxable year 1955 is $10,000. The trust had undistributed net income for the taxable year 1954 of $5,000, to which a tax of $1,100 was allocable. During the taxable year 1955, the trustee distributes $10,000 to A and $5,000 to B. Thus, of the total distribution of $15,000, A received two-thirds and B received one-third.

(b) For the purposes of determining the amounts includible in the beneficiaries' gross income for 1955, the trust is deemed to have made the following distributions:

Amount distributed out of 1955 income (distributable net income)	$10,000
Accumulation distribution deemed distributed by the trust on the last day of 1954 under section 666 (a)	5,000
Taxes imposed on the trust deemed distributed under section 666 (b)	1,100

(c) A will include in his gross income for 1955 two-thirds of each item shown in paragraph (b) of this example. Thus, he will include in gross income $6,666.67 (10,000/15,000×$10,000) of the 1955 distributable net income of the trust as provided in section 662(a)(2), and $3,333.33 (10,000/15,000×$5,000) of the accumulation distribution and $733.33 (10,000/15,000×$1,100) of the taxes imposed on the trust as provided in section 668(a).

(d) B will include in his gross income for 1955 one-third of each item shown in paragraph (b) of this example, computed in the manner shown in paragraph (c) of this example.

§ 1.668(a)–3 Excluded amounts.

When a trust pays, credits, or is required to distribute to a beneficiary amounts which are excluded under sec-

tion 665(b) (1), (2), (3), or (4) from the computation of an accumulation distribution, the amount includible under subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, in the gross income of the beneficiaries pursuant to § 1.668(a)-1 is first allocated to the beneficiaries as provided in § 1.668(a)-2 and, second, the amount allocable to the beneficiary receiving amounts which are excluded under section 665(b) (1), (2), (3), or (4) is reduced by the excluded amounts. This section may be illustrated by the following examples, in which it is assumed the trusts and beneficiaries report on the calendar year basis and the income of the trusts was derived entirely from taxable interest:

Example (1). (a) A trust in 1957 has income as defined in section 643 (b) of $35,000 and expenses allocable to corpus of $5,000. Its distributable net income is, therefore, $30,000 ($35,000—$5,000). The undistributed net income of the trust and the taxes imposed on the trust were $12,840 and $7,260, respectively, for each of the years 1956, 1955, and 1954. The terms of the trust instrument provide for the accumulation of income during the minority of beneficiaries A and B. However, the trustee may make discretionary distributions to either beneficiary after he becomes 21 years of age. Also, the trustee may invade corpus for the benefit of A and B. B became 21 years of age on January 1, 1957, and, as of that date, A was 25 years old. The trustee distributed $50,000 each to A and B during 1957.

(b) Since each beneficiary received one-half of the total amount distributed by the trust, each must include in gross income under section 662 (a) (2) one-half ($15,000) of the distributable net income ($30,000) of the trust for 1957.

(c) The excess distribution of $35,000 ($50,000—$15,000) received by B is excluded from the determination of an accumulation distribution under section 665 (b) (1) and accordingly is not includible in B's gross income under section 668 (a). Nor is such amount treated as an accumulation distribution for the purpose of determining the amount includible in A's gross income under section 668 (a).

(d) The accumulation distribution of the trust is $35,000, computed as follows:

Total distribution by the trust		$100,000
Less:		
Distributable net income for 1957	$30,000	
Excess distribution to B	35,000	
		65,000
Accumulation distribution to A		35,000

(e) The accumulation distribution of $35,000 will be allocated to the preceding taxable years 1956, 1955, and 1954, and the trust will be deemed to have made the following distributions to A on the last day of those years:

	1956	1955	1954	Total
Undistributed net income	$12,840	$12,840	$9,320	$35,000
Taxes imposed on the trust	7,260	7,260	5,270	19,790
Total	20,100	20,100	14,590	54,790

Thus, A will include $54,790 in his gross income for 1957 under section 668 (a). A will, however, receive credit against his tax under section 668 (b).

Example (2). (a) Under the terms of a trust the trustee may make discretionary distributions out of income to A during her life. The balance of the income is to be accumulated during the minority of her son, B, and is to be distributed to him when he becomes 21 years of age. Thereafter the trustee may also make discretionary payments of income to B. Also, the trustee may invade corpus for the benefit of A and B. B became 21 years of age on December 31, 1955. The distributable net income of the trust for 1955 is $30,000. It had undistributed net income of $12,840 for the preceding taxable year 1954 and the taxes imposed on the trust for such year were $7,260. The trustee distributed $15,000 to A during 1955 and on December 31, 1955, he distributed $60,000 to B, which represented income accumulated during his minority.

(b) Since B received four-fifths of the total amount ($75,000) distributed by the trust during 1955, he must include in his gross income under section 662 (a) (2) four-fifths ($24,000) of the distributable net income ($30,000) of the trust for 1955. A will include in her gross income under section 662 (a) (2) one-fifth ($6,000) of the distributable net income ($30,000) of the trust for 1955.

(c) The excess distribution of $36,000 ($60,000—$24,000) received by B is excluded from the determination of an accumulation distribution under section 665 (b) (1) and accordingly is not includible in his gross income under section 668 (a).

(d) The amount treated as an accumulation distribution for the purpose of determining the amount includible in A's gross income for 1955 under section 668 (a) is $9,000, computed as follows:

Total distribution by the trust		$75,000
Less:		
Distributable net income for 1955	$30,000	
Excess distribution to B	36,000	
		66,000
Amount treated as an accumulation distribution		9,000

(e) Inasmuch as the amount of $9,000 is less than the total undistributed net income of the trust ($12,840) for the preceding taxable year 1954, a pro rata portion of the taxes imposed on the trust for that year are also deemed distributed by the trust. Thus, A will include $14,089 in her gross income for 1955 under section 668 (a) computed as follows:

	1954
Accumulation distribution	$9,000
Taxes imposed on the trust (9,000/12,840×$7,260)	5,089
Total	14,089

A will, however, receive credit against her tax under section 668 (b).

§ 1.668(a)-4 Tax attributable to throwback.

(a) The tax attributable to amounts deemed distributed under section 666 is imposed on the beneficiary for the taxable year of the beneficiary in which the accumulation distribution is made unless the taxable year of the beneficiary is different from that of the trust (see section 662 (c) and the regulations thereunder). However, the tax cannot be greater than the aggregate of the taxes attributable to those amounts had they been included, in accordance with the provisions of section 662 (a) (2) and (b), in the gross income of the beneficiary for the preceding taxable year or years in which they were deemed distributed. The tax liability of the beneficiary for the taxable year is computed in the following manner:

(1) First, compute the amount of tax for the taxable year attributable to the section 666 amounts which are included in the gross income of the beneficiary for the year. The tax attributable to those amounts is the difference between the tax for the taxable year computed with the inclusion of the section 666 amounts in gross income and the tax computed without including them in gross income.

(2) Next, compute the tax attributable to the section 666 amounts for each of the preceding taxable years as if they had been included in gross income for those years. The tax attributable to such amounts in each such preceding taxable year is the difference between the tax for such preceding year computed with the inclusion of the section 666 amounts in gross income and the tax for such year computed without including them in gross income. The tax computation for each preceding year shall reflect the taxpayer's marital and dependency status for that year.

(3) The total tax for the taxable year is the tax for that year computed without including the section 666 amounts, *plus*—

(i) The amount of the tax for the taxable year attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph),

or

(ii) The sum of the taxes for the preceding taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (2) of this paragraph),

whichever is the smaller.

(b) The provisions of paragraph (a) of this section may be illustrated by the following example:

Example. (1) During the taxable year 1956, $10,000 is deemed distributed under section 666 to a beneficiary, of which $6,000 is deemed distributed by the trust on the last day of 1955 and $4,000 on the last day of 1954. The beneficiary had taxable income (after deductions) from other sources of $5,000 for 1956, $10,000 for 1955, and $10,000 for 1954. The beneficiary's tax liability for 1956 is $4,730 determined as follows:

Year 1956

Tax on $15,000 (taxable income including section 666 amounts)	$4,730
Tax on $5,000 (taxable income excluding section 666 amounts)	1,100
Tax attributable to section 666 amounts	3,630

Year 1955

Tax on $16,000 (taxable income including section 666 amounts)	$5,200
Tax on $10,000 (taxable income excluding section 666 amounts)	2,640
Tax attributable to section 666 amounts	2,560

Year 1954	
Tax on $14,000 (taxable income including section 666 amounts)	$4,260
Tax on $10,000 (taxable income excluding section 666 amounts)	2,640
Tax attributable to section 666 amounts	1,620

(2) Inasmuch as the tax of $3,630 attributable to the section 666 amounts as computed at 1956 rates is less than the aggregate of the taxes of $4,180 ($2,560 plus $1,620) determined for the preceding taxable years, the amount of $3,630 is added to the tax ($1,100) computed for 1956 without including the section 666 amounts.

§ 1.668(b) Statutory provisions; excess distributions by trusts; treatment of amounts deemed distributed in preceding years; credit for taxes paid by trust.

SEC. 668. *Treatment of amounts deemed distributed in preceding years.* * * *

(b) *Credit for taxes paid by trust.* The tax imposed on beneficiaries under this chapter shall be credited with a pro rata portion of the taxes imposed on the trust under this chapter for such preceding taxable year which would not have been payable by the trust for such preceding taxable year had the trust in fact made distributions to such beneficiaries at the times and in the amounts specified in section 666.

§ 1.668(b)–1 Credit for taxes paid by the trust.

(a) The taxes imposed on a complex trust for a taxable year which would not have been payable by the trust if amounts deemed under section 660 to have been distributed in the year had in fact been distributed in the year are not allowable as a refund to the trust but are allowable as a credit against the tax of the beneficiaries to whom the amounts described in section 666 (a) are distributed.

(b) The credit to which a beneficiary is entitled under section 668 (b) is allowed for the taxable year in which the accumulation distribution (to which the credit relates) is required to be included in the gross income of the beneficiary. Any excess over the total tax liability of the beneficiary is treated as an overpayment of tax by the beneficiary.

(c) The beneficiary is entitled to a portion of the credit described in paragraph (a) of this section in the ratio which the amount of the accumulation distribution to him bears to the accumulation distributions to all the beneficiaries.

§ 1.668(b)–2 Illustration of the provisions of subpart D.

The provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, may be illustrated by the following example:

Example. (a) *Facts.* (1) Under the terms of a trust instrument, one-half of the trust income is required to be distributed currently to beneficiary A. The trustee may in his discretion accumulate the balance of the income of the trust or he may make distributions to B out of income or corpus. The trust is to terminate upon the death of A and the corpus is to be distributed to B. Capital gains are allocable to corpus. All of the expenses of the trust are charges against income. The trust instrument provides for a reserve for depreciation, so that depreciation is deductible in computing distributable net income. The trust and both beneficiaries report on the calendar year basis. The trust had long-term capital gains of $20,000 for 1954, and $10,000 for 1955, which were allocated to corpus. The distributable net income of the trust as determined under section 643 (a) for 1954, 1955, 1956, and 1957 is deemed to consist of the following items of income:

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1954	$15,000	$20,000	$10,000	$5,000	$50,000
1955	10,000	15,000	10,000	5,000	40,000
1956	10,000	20,000	15,000	5,000	50,000
1957	10,000	15,000	15,000	5,000	45,000

(2) One-half ($7,500) of the dividends for 1954 was received by the trust on or before July 31, 1954, and the balance was received after that date.

(3) The following distributions were made by the trustee to A and B during the taxable years 1954 through 1957:

	A	B
1954	$25,000	None
1955	20,000	None
1956	25,000	$45,000
1957	22,500	29,550

(b) *Distributions to A.* A is deemed to have received one-half of each item of income entering into the computation of distributable net income as shown in paragraph (a)(1) of this example. See § 1.662 (a)–2 for rules for the treatment of currently distributable income in the hands of the beneficiary.

(c) *Tax liability of the trust*—(1) *1954.* (i) The tax liability of the trust for the taxable year 1954 is $13,451, computed as follows:

Distributable net income under section 643(a) (paragraph (a)(1) of this example)		$50,000
Less amounts not includible in gross income:		
Tax-exempt interest	$5,000	
Dividend exclusion	50	5,050
Distributable net income as adjusted		44,950
Add: Capital gains (long-term)		20,000
Total		64,950
Deductions:		
Distributions to A	$22,475	
Capital gain deduction	10,000	
Personal exemption	100	32,575
Taxable income		32,375
Alternative tax		13,601
Dividend received credit		150
Tax liability		13,451

(ii) See paragraph (b) of this example for character of income deemed distributed to A and section 661 for rules for computing the amount deductible by a trust for distributions to beneficiaries. Inasmuch as one-half of the dividends of the trust is deemed to be distributed to A, $25 of such distribution is deemed to be made from the dividend exclusion of $50, and the balance from dividends included in the gross income of the trust (that is, since the year 1954 is involved, $3,725 from dividends received on or before July 31, 1954, and $3,750 from dividends received after July 31, 1954). The trust is entitled to a dividend received credit attributable to the dividends of $3,750 received after July 31, 1954, which were not distributed to any beneficiary during the taxable year.

(2) *1955.* (i) The tax liability of the trust for the taxable year 1955 is $8,189, computed as follows:

Distributable net income under section 643(a) (paragraph (a)(1) of this example)		$40,000
Less amounts not includible in gross income:		
Tax-exempt interest	$5,000	
Dividend exclusion	50	5,050
Distributable net income as adjusted		34,950
Add: Capital gains (long-term)		10,000
Total		44,950
Deductions:		
Distributions to A	$17,475	
Capital gain deduction	5,000	
Personal exemption	100	22,575
Taxable income		22,375
Alternative tax		$8,388
Dividend received credit		199
Tax liability		8,189

(ii) See paragraph (b) of this example for character of income deemed distributed to A and section 661 for rules for computing the amount deductible by a trust for distributions to beneficiaries. Inasmuch as one-half ($4,975) of the dividends of $9,950 ($10,000 less dividend exclusion of $50) included in the gross income of the trust is deemed distributed to A, the trust is entitled to a dividend received credit with respect to the dividends of $4,975 which were not distributed to any beneficiary during the taxable year.

(3) *1956 and 1957.* The trust had no tax liability for the taxable years 1956 and 1957 since all of its income was distributed during such years.

(d) *Accumulation distributions.* (1) Accumulation distributions of $20,000 and $7,050, as defined in section 665 (b), were made to B during the years 1956 and 1957, respectively, computed as shown below:

	1956	1957
Distributable net income of the trust as computed under section 643 (a)	$50,000	$45,000
Less: Income currently distributable to A	25,000	22,500
Balance of income	25,000	22,500
Other amounts distributed to B	45,000	29,550
Accumulation distributions to B	20,000	7,050

(2) B is deemed to have received one-half of each item of income entering into the computation of distributable net income (shown in paragraph (a)(1) of this example) for the years 1956 and 1957.

(3) The accumulation distribution for 1956 must first be allocated to the preceding taxable years as provided in section 666. After the application of the provisions of subpart D to the 1956 accumulation distribution and to the undistributed net incomes of the preceding taxable years, a similar allocation must be made of the 1957 accumulation distribution.

(e) *Throwback of 1956 accumulation distribution to 1955.* The accumulation distribution of $20,000 for 1956 must be allocated to the first preceding taxable year 1955, before allocation is made to the second preceding taxable year 1954.

(1) *1955 Undistributed net income.* (i) The undistributed net income of the trust for 1955, determined as of the close of 1955, is $12,885, computed as follows:

Distributable net income as computed under section 643 (a) (paragraph (a)(1) of this example)		$40,000

Less:		
Distributions to A	$20,000	
Taxes imposed on the trust	7,115	
		27,115
Undistributed net income as of the close of 1955		12,885

(ii) The taxes imposed on the trust of $7,115 are that portion of the taxes paid by the trust for 1955 which is attributable to the undistributed portion of distributable net income included in the taxable income of the trust (the "balance" in the computation below) and is determined as follows:

Taxable income (paragraph (c) (2) (i) of this example)		$22,375
Capital gains allocable to corpus	$10,000	
Less:		
Capital gain deduction	$5,000	
Personal exemption	100	
	5,100	
Portion of taxable income allocable to corpus		4,900
Balance		17,475
Total taxes paid by the trust		$8,189
Taxes on income ($4,900) allocable to corpus		1,074
Taxes imposed on the trust (section 665 (c))		7,115

(iii) The amount of $1,074 is the taxes which the trust would have paid for 1955 had all of the distributable net income been distributed during the year.

(2) *Allocation of 1956 accumulation distribution to the preceding taxable year 1955.* The portion of the 1956 accumulation distribution which is deemed under section 666 (a) to be distributed to B on the last day of 1955 (the first preceding taxable year) is $12,885, an amount equal to the undistributed net income for 1955. An additional amount equal to the taxes imposed on the trust ($7,115) is, under section 666 (b), also deemed to be distributed to B on the last day of 1955. Thus, a total of $20,000 ($12,885 plus $7,115) is deemed to be distributed to B on December 31, 1955, by reason of the allocation of the 1956 accumulation distribution to the first preceding taxable year. See paragraph (h) of this example for the treatment of the amount of $20,000 in the hands of B.

(3) *Character of amounts deemed distributed.* Inasmuch as one-half of the 1955 distributable net income of the trust as determined under section 643 (a) was currently distributable to A and the balance of such income is deemed under section 666 to be distributed to B on December 31, 1955, the distribution to B is deemed to consist of one-half of each item of income entering into the computation of the 1955 distributable net income; that is, dividends of $5,000, rents of $7,500, taxable interest of $5,000, and tax-exempt interest of $2,500.

(4) *Credit for taxes paid by the trust.* The amount of the taxes for the year 1955 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B for 1956 under section 668 (b) is $7,115. See also paragraph (h) (3) of this example.

(5) *Effect of application of provisions of subpart D to the year 1955.* After the allocation of the 1956 accumulation distribution to the preceding taxable year 1955, the undistributed portion of the distributable net income, the undistributed net income, and the taxes imposed on the trust for 1955 are zero. The portion of the 1956 accumulation distribution which is unabsorbed by the 1955 undistributed net income is $7,115, determined as follows:

1956 accumulation distribution (paragraph (d) (1) of this example)	$20,000
Less: Amount allocable to 1955	12,885
Balance allocable to second preceding taxable year 1954	7,115

(f) *Throwback of 1956 accumulation distribution to 1954.* The unabsorbed portion of the 1956 accumulation distribution of $7,115 is allocable to the second preceding taxable year 1954 and is treated under section 666 as a distribution to B on the last day of such year.

(1) *1954 Undistributed net income.* (i) The undistributed net income of the trust for 1954, determined as of the close of 1954, is $14,155, computed as follows:

Distributable net income as computed under section 643 (a) (paragraph (a) (1) of this example)		$50,000
Less:		
Distributions to A	$25,000	
Taxes imposed on the trust	10,845	
		35,845
Undistributed net income as of the close of 1954		14,155

(ii) The taxes imposed on the trust of $10,845 are that portion of the taxes paid by the trust for 1954 which is attributable to the undistributed portion of distributable net income included in the taxable income of the trust (the "balance" in the computation below in this subdivision) and is determined as follows:

Taxable income (paragraph (c) (1) (i) of this example)		$32,375
Capital gains allocable to corpus	$20,000	
Less:		
Capital gain deduction	$10,000	
Personal exemption	100	
	$10,000	
Portion of taxable income allocable to corpus		$9,900
Balance		22,475
Total taxes paid by the trust		$13,451
Taxes on income ($9,900) allocable to corpus		2,606
Taxes imposed on the trust (section 665 (c))		10,845

(iii) The amount of $2,606 is the taxes which the trust would have paid for 1954 had all of the distributable net income been distributed during that year.

(2) *Allocation of 1956 accumulation distribution to the second preceding taxable year 1954.* Since the unabsorbed portion of the 1956 accumulation distribution of $7,115 is less than the 1954 undistributed net income of $14,155, the trust is deemed under section 666 (c) to have also distributed an additional amount ($5,451) equal to a pro rata portion (7,115/14,155×$10,845) of the taxes imposed on the trust for 1954. Thus, a total of $12,566 ($7,115 plus $5,451) is deemed to be distributed to B on December 31, 1954, by reason of the throwback of the 1956 accumulation distribution. See paragraph (h) of this example for the treatment of the amount of $12,566 in the hands of B.

(3) *Character of amounts deemed distributed to B.* The amount of $12,566 which, under section 666, is deemed to be distributed to B on December 31, 1954, is deemed to be composed of the following items of income of the trust: Dividends, $3,770 (15,000/50,000×$12,566); rents, $5,026 (20,000/50,000×$12,566); taxable interest, $2,513 (10,000/50,000×$12,566); and tax-exempt interest, $1,257 (5,000/50,000×$12,566). One-half of the dividends of $3,770 is considered as distributed from the dividends received by the trust on or before July 31, 1954, of which $13 (3,770/15,000×$50) is deemed distributed from the dividends excluded under section 116, and the other half as distributed from the dividends received after July 31, 1954. Thus, of the total of $12,566 deemed distributed to B, $11,296 is considered as made from income included in the gross income of the trust and $1,270 from nontaxable income of the trust.

(4) *Credit for taxes paid by the trust.* The amount of the taxes for the year 1954 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B for 1956 under section 668 (b), because of the allocation of the 1956 accumulation distribution to 1954, is $5,401, computed as follows:

Taxable income of the trust as of the close of 1954 (paragraph (c) (1) of this example)		$32,375
Less: Amount deemed distributed to B under section 666 from the taxable income of the trust		11,296
Taxable income adjusted as of the close of 1956		21,079
Taxes on $21,079 (alternative tax)		$8,050
Taxes on income allocable to corpus (subparagraph (1) (ii) of this paragraph)		2,606
Taxes imposed on the trust determined as of the close of 1956		5,444
Taxes imposed on the trust determined as of the close of 1954		$10,845
Taxes imposed on the trust determined as of the close of 1956		5,444
Amount of taxes allowed as a credit to B under section 668 (b)		5,401

(5) *Effect of application of provisions of subpart D to the year 1954.* (i) The undistributed portion of the distributable net income of the trust for the year 1954, determined as of the close of 1956, is $12,434, computed as follows:

Distributable net income (section 643 (a))		$50,000
Less:		
Amount currently distributable to A	$25,000	
Amount deemed distributed to B under section 666	12,566	
		37,566
Undistributed portion of distributable net income as of the close of 1956		12,434

(ii) The amount of $12,434 is deemed to consist of dividends of $3,730, rents of $4,974, taxable interest of $2,487, and tax-exempt interest of $1,243, determined as follows:

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
Trust income	$15,000	$20,000	$10,000	$5,000	[1] $50,000
Distributions:					
To A	7,500	10,000	5,000	2,500	[2] 25,000
To B	3,770	5,026	2,513	1,257	[3] 12,566
Total	11,270	15,026	7,513	3,757	37,566
Balance	3,730	4,974	2,487	1,243	12,434

[1] See paragraph (a) (1) of this example.
[2] See paragraph (b) of this example.
[3] See paragraph (f) (3) of this example.

(iii) The undistributed net income of the trust for 1954, determined as of the close of 1956, is $6,990, computed as follows:

Undistributed portion of distributable net income as of the close of 1956	$12,434
Less: Taxes imposed on the trust determined as of the close of 1956 (subparagraph (4) of this paragraph)	5,444
Undistributed net income as of the close of 1956	6,990

(g) *Throwback of 1957 accumulation distribution.* Inasmuch as all of the income of the trust for the first preceding taxable year 1956 was distributed during such year and the trust had no undistributed net income for the second preceding taxable year 1955 after the application of subpart D to the accumulation distribution made during 1956, the 1957 accumulation distribution of $7,050 is allocable to the third preceding taxable year 1954. See paragraph (d)(1) of this example for computation of the accumulation distribution.

(1) *Allocation of 1957 accumulation distribution to the preceding taxable year 1954.* The portion of the 1957 accumulation distribution which is deemed under section 666 (a) to be distributed to B on the last day of 1954 is $6,990, an amount equal to the undistributed net income of the trust for 1954, determined as of the close of 1956. An additional amount equal to the taxes imposed on the trust ($5,444), determined as of the close of 1956, is under section 666 (b) also deemed to be distributed to B on the last day of 1954. See paragraph (f) (4) and (5) of this example. Thus, a total of $12,434 ($6,990 plus $5,444) is deemed to be distributed to B on December 31, 1954, by reason of the allocation of the 1957 accumulation distribution to the taxable year 1954. See paragraph (j) of this example for the treatment of the amount of $12,434 in the hands of B.

(2) *Character of amounts deemed distributed.* Inasmuch as the balance of the 1954 distributable net income of the trust is deemed under section 666 to be distributed to B on December 31, 1954, the distribution is deemed to consist of dividends of $3,730, rents of $4,974, taxable interest of $2,487, and tax-exempt interest of $1,243. See paragraph (f) (5) (ii) of this example.

(3) *Credit for taxes paid by the trust.* The amount of taxes for the year 1954 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B under section 668 (b) is $5,444, the amount of taxes imposed on the trust determined as of the close of 1956. See paragraph (f) (4) of this example.

(4) *Effect of application of provisions of subpart D to the year 1954.* After the allocation of the 1957 accumulation distribution to the preceding taxable year 1954, the undistributed portion of the distributable net income, the undistributed net income, and the taxes imposed on the trust for 1954 are zero. The balance of $60 ($7,050 less $6,990) of the 1957 accumulation distribution remaining after the allocation of the accumulation distribution to the year 1954, may not be allocated to the year 1953 since that year is not subject to the provisions of the Internal Revenue Code of 1954.

(h) *Determination of B's tax liability; taxable year 1956*—(1) *Amount of trust income includible in gross income.* (i) Of the amount of $45,000 distributed by the trust to B during the taxable year 1956, $25,000 is treated as a distribution out of trust income for that year within the meaning of section 662 (a) (2), and $20,000 as an accumulation distribution within the meaning of section 665 (b) (see paragraph (d) of this example). However, $12,885 plus taxes of $7,115 is deemed distributed to B on December 31, 1955, and $7,115 plus taxes of $5,451 on December 31, 1954, under section 666 by reason of the accumulation distribution made during 1956, and these amounts are includible in B's gross income for 1956 to the extent that they would have been includible in his gross income under section 662 (a) (2) and (b) for 1955 and 1954, respectively, had they been distributed on the last day of those years.

(ii) The amounts distributed to B out of trust income for the year 1956, and the amounts deemed distributed out of income for the preceding taxable years 1955 and 1954 have the following character for the purpose of determining the amount includible in B's gross income for 1956:

Year	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1956	$5,000	$10,000	$7,500	$2,500	[1] $25,000
1955	5,000	7,500	5,000	2,500	[2] 20,000
1954	3,770	5,026	2,513	1,257	[3] 12,566
Total	13,770	22,526	15,013	6,257	57,566

[1] See paragraph (d)(2) of this example.
[2] See paragraph (e)(3) of this example.
[3] See paragraph (f)(3) of this example.

Thus, B will include in gross income for 1956 dividends of $13,770 (subject to the dividend exclusion), rents of $22,526, and taxable interest of $15,013, and will exclude the tax-exempt interest of $6,257.

(2) *Computation of tax.* (i) For the purpose of computing B's tax liability, it is assumed that he was single during the taxable years 1954, 1955, and 1956, and that his taxable income (derived from salary) for each of the years 1954 and 1955 amounted to $13,400 on which a tax of $4,002 was paid for each year. It is also assumed that his income (other than distributions from the trust) for 1956 was $15,000 derived from salary, and he had allowable deductions of $10,600, which included the deduction for personal exemption.

(ii) The computation of the tax for the taxable year 1956 attributable to the section 666 amounts which are included in B's gross income for such year, as provided in paragraph (a) (1) of § 1.668 (a)–4, is as follows:

	(1) Section 666 amounts excluded	(2) Section 666 amounts included
Salary	$15,000	$15,000
Income from trust:		
Dividends ($50 excluded)	4,950	13,720
Rents	10,000	22,526
Taxable interest	7,500	15,013
Total	37,450	66,259
Less: Allowable deductions	10,600	10,600
Taxable income	26,850	55,659
Total tax	11,267	31,064
Less: Dividend received credit	198	475
Tax liability	11,069	30,589
Tax on income from which section 666 amounts are excluded		11,069
1956 tax attributable to section 666 amounts		19,520

Only that portion of the dividends received by the trust after July 31, 1954, and deemed distributed to B under section 666, on the last day of such year is included in computing the dividend received credit shown in column (2). See paragraph (f)(3) of this example

(iii) The computation of the taxes for the preceding taxable years attributable to the section 666 amounts which are deemed distributed by the trust on the last day of these years, as provided in paragraph (a) (2) of § 1.668 (a)–4, is as follows:

	Preceding taxable years	
	First 1955	Second 1954
Taxable income previously reported	$13,400	$13,400
Section 666 amounts:		
Dividends ($50 excluded)	4,950	3,720
Rents	7,500	5,026
Taxable interest	5,000	2,513
Taxable income as adjusted	30,850	24,659
Total tax	13,747	9,949
Less: Dividend received credit	198	75
Balance of tax	13,549	9,874
Tax liability	4,002	4,002
Tax attributable to section 666 amounts	9,547	5,872

Only that portion ($1,885) of the dividends received by the trust after July 31, 1954, and deemed distributed under section 666 on the last day of that year, is included in computing the dividend received credit of $75 for the year 1954. See paragraph (f)(3) of this example.

(iv) Inasmuch as the aggregate of the taxes of $15,419 ($9,547 plus $5,872) attributable to the section 666 amounts as determined for the preceding taxable years is less than the tax of $19,520 determined for the taxable year 1956, the amount of $15,419 shall be added to the tax computed for 1956 without including the section 666 amounts. Thus, B's tax liability for 1956 is $26,488 ($11,069 plus $15,419).

(3) *Credits against the tax.* B is allowed under section 668 (b) a credit of $12,516 ($5,401 for 1954 and $7,115 for 1955) against his 1956 tax liability for the taxes paid by the trust for the preceding taxable years and which may not be refunded or credited to the trust under section 667. See paragraphs (e) (4) and (f)(4) of this example.

(i) [Reserved]

(j) *Taxable year 1957*—(1) *Amount of trust income includible in gross income.* (i) Of the amount of $29,550 distributed by the trust to B during the taxable year 1957, $22,500 is treated as a distribution out of trust income for that year within the meaning of section 662 (a) (2), and $7,050 as an accumulation distribution within the meaning of section 665(b) (see paragraph (d) of this example). However, $6,990 plus taxes of $5,444 is deemed distributed to B on December 31, 1954, under section 666 by reason of the accumulation distribution made during 1957, and that amount is includible in B's gross income for 1957, to the extent that it would have been includible in his gross income under section 662 (a)(2) and (b) for 1954, had it been distributed on the last day of that year.

(ii) The amounts deemed distributed to B out of trust income for the year 1957 and the preceding taxable year 1954 are deemed to have the following character for the purpose of determining the amount includible in B's gross income for 1957:

Year	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1957	$5,000	$7,500	$7,500	$2,500	[1] $22,500
1954	3,730	4,974	2,487	1,243	[2] 12,434
Total	8,730	12,474	9,987	3,743	34,934

[1] See paragraph d(2) of this example.
[2] See paragraph (g)(2) of this example.

Thus, B will include in gross income for the year 1957 dividends of $8,730 (subject to the dividend exclusion), rents of $12,474, and

taxable interest of $9,987 and will exclude the tax-exempt interest of $8,743.

(2) *Computation of tax.* (i) For the purpose of computing B's tax liability for 1957, it is assumed that he was single for the entire year and had income (other than distributions from the trust) of $15,000 from salary. Also, he had allowable deductions of $8,100, which included the deductions for personal exemption.

(ii) The computation of the tax for the taxable year 1957 attributable to the section 666 amounts which are included in B's gross income for that year, as provided in paragraph (a) (1) of § 1.668 (a)–4, is as follows:

	Section 666 amounts excluded	Section 666 amounts included
Salary	$15,000	$15,000
Trust income:		
Dividends ($50 excluded)	4,950	8,680
Rents	7,500	12,474
Taxable interest	7,500	9,987
Total	34,950	46,141
Less: Allowable deductions	8,100	8,100
Taxable income	26,850	38,041
Total tax	11,267	18,388
Less: Dividends received credit	198	275
Tax liability	11,069	18,113
Tax on income from which section 666 amounts are excluded		11,069
1957 tax attributable to section 666 amounts		7,044

See explanation following computation in paragraph (h) (2) (ii) of this example with respect to the computation of the dividend received credit on dividends received by the trust in 1954.

(iii) The amount of tax, computed at 1954 rates, attributable to the section 666 amounts which are deemed to have been distributed by the trust on the last day of 1954, is $6,939, computed as follows:

1954 taxable income as adjusted (paragraph (h) (2) (iii) of this example)		$24,659
Section 666 amounts:		
Dividends	3,730	
Rents	4,974	
Taxable interest	2,487	
Taxable income as adjusted		35,850
Total tax		16,963
Less: Dividends received credit		150
Balance of tax		16,813
Tax liability for 1954		$4,002
Tax attributable to 1956 accumulation distribution this example)	$5,872	
		$9,874
Tax attributable to the section 666 amounts distributed in 1957		6,939

Only that portion ($8,750) of the dividends received by the trust after July 31, 1954, and deemed distributed under section 666 on the last day of that year, is included in computing the dividend received credit of $150. See paragraphs (f) (3) and (g) (2) of this example.

(iv) Inasmuch as the tax of $6,939 attributable to the section 666 amounts as determined for the preceding taxable year 1954 is less than the tax of $7,044 attributable to these amounts for the year 1957, the amount of $6,939 shall be added to the tax computed for 1957 without including in gross income the section 666 amounts. Thus, B's tax liability for 1957 is $18,008 ($11,069 plus $6,939).

(3) *Credit against the tax.* B is allowed under section 668 (b) a credit of $5,444 against his 1957 tax liability for the balance of the taxes paid by the trust for 1954 and which may not be refunded or credited to the trust under section 667. See paragraph (g) (3) of this example.

GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS

§ 1.671 Statutory provisions; estates and trusts; grantors and others treated as substantial owners; income, deductions, and credits attributable to grantors and others as substantial owners.

SEC. 671. *Trust income, deductions, and credits attributable to grantors and others as substantial owners.* Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

§ 1.671–1 Grantors and others treated as substantial owners; scope.

(a) Subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, contains provisions taxing income of a trust to the grantor or another person under certain circumstances even though he is not treated as a beneficiary under subparts A through D (section 641 and following) of such part I. Sections 671 and 672 contain general provisions relating to the entire subpart. Sections 673 through 677 define the circumstances under which income of a trust is taxed to a grantor. These circumstances are in general as follows:

(1) If the grantor has retained a reversionary interest in the trust, within specified time limits (section 673);

(2) If the grantor or a nonadverse party has certain powers over the beneficial interests under the trust (section 674);

(3) If certain administrative powers over the trust exist under which the grantor can or does benefit (section 675);

(4) If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor (section 676); or

(5) If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor (section 677).

Under section 678, income of a trust is taxed to a person other than the grantor to the extent that he has the sole power to vest corpus or income in himself.

(b) Sections 671 through 677 do not apply if the income of a trust is taxable to a grantor's spouse under section 71 or 682 (relating respectively to alimony and separate maintenance payments, and the income of an estate or trust in the case of divorce, etc.).

(c) Except as provided in such subpart E, income of a trust is not included in computing the taxable income and credits of a grantor or another person solely on the grounds of his dominion and control over the trust. However, the provisions of subpart E do not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. Thus, for example, a person who assigns his right to future income under an employment contract may be taxed on that income even though the assignment is to a trust over which the assignor has retained none of the controls specified in sections 671 through 677. Similarly, a bondholder who assigns his right to interest may be taxed on interest payments even though the assignment is to an uncontrolled trust. Nor are the rules as to family partnerships affected by the provisions of subpart E, even though a partnership interest is held in trust. Likewise, these sections have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement. In addition, the limitation of the last sentence of section 671 does not prevent any person from being taxed on the income of a trust when it is used to discharge his legal obligation. See § 1.662 (a)–4. He is then treated as a beneficiary under subparts A through D or treated as an owner under section 677 because the income is distributed for his benefit, and not because of his dominion or control over the trust.

(d) For the effective date of subpart E see section 683 and the regulations thereunder.

§ 1.671–2 Applicable principles.

(a) Under section 671 a grantor or another person includes in computing his taxable income and credits those items of income, deduction, and credit against tax which are attributable to or included in any portion of a trust of which he is treated as the owner. Sections 673 through 678 set forth the rules for determining when the grantor or another person is treated as the owner of any portion of a trust. The rules for determining the items of income, deduction, and credit against tax that are attributable to or included in a portion of the trust are set forth in § 1.671–3.

(b) Since the principle underlying subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. Accordingly, when it is stated

in the regulations under subpart E that "income" is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in § 1.643(b)–1 is meant, the phrase "ordinary income" is used.

(c) An item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual). For example, a charitable contribution made by a trust which is attributed to the grantor (an individual) under sections 671 through 677 will be aggregated with his other charitable contributions to determine their deductibility under the limitations of section 170(b)(1). Likewise, dividends received by a trust from sources in a particular foreign country which are attributed to a grantor or another person under subpart E will be aggregated with his other income from sources within that country to determine whether the taxpayer is subject to the limitations of section 904 with respect to credit for the tax paid to that country.

(d) Items of income, deduction, and credit not attributed to or included in any portion of a trust of which the grantor or another person is treated as the owner under subpart E are subject to the provisions of subparts A through D (section 641 and following), of such part I.

(e) The term "grantor" as used in the regulations under subpart E includes a corporation.

§ 1.671–3 Attribution or inclusion of income, deductions, and credits against tax.

(a) When a grantor or another person is treated under subpart E (section 671 and following) as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example:

(1) If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.

(2) If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 671 and following), part I, subchapter J, chapter 1 of the Code. Items that relate both to the portion treated as owned by the grantor and to the balance of the trust must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent.

(3) If the portion of a trust treated as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question. The share not treated as owned by the grantor or other person is governed by the provisions of subparts A through D. See the last three sentences of paragraph (c) of this section for the principles applicable if the portion treated as owned consists of an interest in part of the ordinary income in contrast to an interest in corpus alone.

(b) If a grantor or another person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus. For example—

(1) Only ordinary income is included by reason of an interest in or a power over ordinary income alone. Thus, if a grantor is treated under section 673 as an owner by reason of a reversionary interest in ordinary income only, items of income allocable to corpus will not be included in the portion he is treated as owning. Similarly, if a grantor or another person is treated under sections 674–678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion. (See paragraph (c) of this section to determine the treatment of deductions and credits when only ordinary income is included in the portion.)

(2) Only income allocable to corpus is included by reason of an interest in or a power over corpus alone, if satisfaction of the interest or an exercise of the power will not result in an interest in or the exercise of a power over ordinary income which would itself cause that income to be included. For example, if a grantor has a reversionary interest in a trust which is not such as to require that he be treated as an owner under section 673, he may nevertheless be treated as an owner under section 677 (a) (2) since any income allocable to corpus is accumulated for future distribution to him, but items of income included in determining ordinary income are not included in the portion he is treated as owning. Similarly, he may have a power over corpus which is such that he is treated as an owner under section 674 or 676 (a), but ordinary income will not be included in the portion he owns, if his power can only affect income received after a period of time such that he would not be treated as an owner of the income if the power were a reversionary interest. (See paragraph (c) of this section to determine the treatment of deductions and credits when only income allocated to corpus is included in the portion.)

(3) Both ordinary income and other income allocable to corpus are included by reason of an interest in or a power over both ordinary income and corpus, or an interest in or a power over corpus alone which does not come within the provisions of subparagraph (2) of this paragraph. For example, if a grantor is treated under section 673 as the owner of a portion of a trust by reason of a reversionary interest in corpus, both ordinary income and other income allocable to corpus are included in the portion. Further, a grantor includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated under section 674 or 676 as an owner because of a power over corpus which can affect income received within a period such that he would be treated as an owner under section 673 if the power were a reversionary interest. Similarly, a grantor or another person includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated as an owner under section 675 or 678 because of a power over corpus.

(c) If only income allocable to corpus is included in computing a grantor's tax liability, he will take into account in that computation only those items of income, deduction, and credit which would not be included under subparts A through D in the computation of the tax liability of the current income beneficiaries if all distributable net income had actually been distributed to those beneficiaries. On the other hand, if the grantor or another person is treated as an owner solely because of his interest in or power over ordinary income alone, he will take into account in computing his tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income. If the grantor or other person is treated as an owner because of his power over or right to a dollar amount of ordinary income, he will first take into account a portion of those items of income and expense entering into the computation of ordinary income under the trust instrument or local law sufficient to produce income of the dollar amount required. There will then be attributable to him a pro rata portion of other items entering into the computation of distributable net income under subparts A through D, such as expenses allocable to corpus, and a pro rata portion of credits of the trust. For examples of computations under this paragraph, see paragraph (g) of § 1.677(a)–1.

§ 1.671–4 Method of reporting.

Items of income, deduction, and credit attributable to any portion of a trust which, under the provisions of subpart

E (section 671 and following), part I, subchapter J, chapter 1 of the Code, are treated as owned by the grantor or another person should not be reported by the trust on Form 1041, but should be shown on a separate statement to be attached to that form.

§ 1.672(a) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; definition of adverse party.

SEC. 672. *Definitions and rules*—(a) *Adverse party.* For purposes of this subpart, the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

§ 1.672(a)–1 Definition of adverse party.

(a) Under section 672(a) an adverse party is defined as any person having a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust. A trustee is not an adverse party merely because of his interest as trustee. A person having a general power of appointment over the trust property is deemed to have a beneficial interest in the trust. An interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant.

(b) Ordinarily, a beneficiary will be an adverse party, but if his right to share in the income or corpus of a trust is limited to only a part, he may be an adverse party only as to that part. Thus, if A, B, C, and D are equal income beneficiaries of a trust and the grantor can revoke with A's consent, the grantor is treated as the owner of a portion which represents three-fourths of the trust; and items of income, deduction, and credit attributable to that portion are included in determining the tax of the grantor.

(c) The interest of an ordinary income beneficiary of a trust may or may not be adverse with respect to the exercise of a power over corpus. Thus, if the income of a trust is payable to A for life, with a power (which is not a general power of appointment) in A to appoint the corpus to the grantor either during his life or by will, A's interest is adverse to the return of the corpus to the grantor during A's life, but is not adverse to a return of the corpus after A's death. In other words, A's interest is adverse as to ordinary income but is not adverse as to income allocable to corpus. Therefore, assuming no other relevant facts exist, the grantor would not be taxable on the ordinary income of the trust under section 674, 676, or 677, but would be taxable under section 677 on income allocable to corpus (such as capital gains), since it may in the discretion of a nonadverse party be accumulated for future distribution to the grantor. Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to the grantor before the termination of his interest but not to a return of corpus after the termination of his interest.

(d) The interest of a remainderman is adverse to the exercise of any power over the corpus of a trust, but not to the exercise of a power over any income interest preceding his remainder. For example, if the grantor creates a trust which provides for income to be distributed to A for 10 years and then for the corpus to go to X if he is then living, a power exercisable by X to revest corpus in the grantor is a power exercisable by an adverse party; however, a power exercisable by X to distribute part or all of the ordinary income to the grantor may be a power exercisable by a nonadverse party (which would cause the ordinary income to be taxed to the grantor).

§ 1.672(b) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; definition of nonadverse party.

SEC. 672. *Definitions and rules.* • • • •

(b) *Nonadverse party.* For purposes of this subpart, the term "nonadverse party" means any person who is not an adverse party.

§ 1.672(b)–1 Nonadverse party.

A "nonadverse party" is any person who is not an adverse party.

§ 1.672(c) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; definition of related or subordinate party.

SEC. 672. *Definitions and rules.* • • •

(c) *Related or subordinate party.* For purposes of this subpart, the term "related or subordinate party" means any nonadverse party who is—

(1) The grantor's spouse if living with the grantor;

(2) Any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

For purposes of sections 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

§ 1.672(c)–1 Related or subordinate party.

Section 672(c) defines the term "related or subordinate party". The term, as used in sections 674(c) and 675(3), means any nonadverse party who is the grantor's spouse if living with the grantor; the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate employee of a corporation in which the grantor is an executive. For purposes of sections 674 (c) and 675 (3), these persons are presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on them unless shown not to be subservient by a preponderance of the evidence.

§ 1.672(d) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; rule where power is subject to condition precedent.

SEC. 672. *Definitions and rules.* • • •

(d) *Rule where power is subject to condition precedent.* A person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.

§ 1.672(d)–1 Power subject to condition precedent.

Section 672(d) provides that a person is considered to have a power described in subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, even though the exercise of the power is subject to a precedent giving of notice or takes effect only after the expiration of a certain period of time. However, although a person may be considered to have such a power, the grantor will nevertheless not be treated as an owner by reason of the power if its exercise can only affect beneficial enjoyment of income received after the expiration of a period of time such that, if the power were a reversionary interest, he would not be treated as an owner under section 673. See sections 674(b)(2), 676(b), and the last sentence of section 677(a). Thus, for example, if a grantor creates a trust for the benefit of his son and retains a power to revoke which takes effect only after the expiration of 2 years from the date of exercise, he is treated as an owner from the inception of the trust. However, if the grantor retains a power to revoke, exercisable at any time, which can only affect the beneficial enjoyment of the ordinary income of a trust received after the expiration of 10 years commencing with the date of the transfer in trust, or after the death of the income beneficiary, the power does not cause him to be treated as an owner with respect to ordinary income during the first 10 years of the trust or during the income beneficiary's life, as the case may be. See section 676(b).

§ 1.673(a) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; reversionary interests.

SEC. 673. *Reversionary interests*—(a) *General rule.* The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.

§ 1.673(a)–1 Reversionary interests; income payable to beneficiaries other than certain charitable organizations; general rule.

(a) Under section 673(a), a grantor, in general, is treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or income if, as of the inception of that portion of the trust, the grantor's interest will or may reasonably be expected to

take effect in possession or enjoyment within 10 years commencing with the date of transfer of that portion of the trust. However, the following types of reversionary interests are excepted from the general rule of the preceding sentence:

(1) A reversionary interest after the death of the income beneficiary of a trust (see paragraph (b) of this section); and

(2) A reversionary interest in a charitable trust meeting the requirements of section 673 (b) (see § 1.673 (b)–1).

Even though the duration of the trust may be such that the grantor is not treated as its owner under section 673, and therefore is not taxed on the ordinary income, he may nevertheless be treated as an owner under section 677 (a) (2) if he has a reversionary interest in the corpus. In the latter case, items of income, deduction, and credit allocable to corpus, such as capital gains and losses, will be included in the portion he owns. See § 1.671–3 and the regulations under section 677. See § 1.673 (d)–1 with respect to a postponement of the date specified for reacquisition of a reversionary interest.

(b) Section 673 (c) provides that a grantor is not treated as the owner of any portion of a trust by reason of section 673 if his reversionary interest in the portion is not to take effect in possession or enjoyment until the death of the person or persons to whom the income of the portion is payable, regardless of the life expectancies of the income beneficiaries. If his reversionary interest is to take effect on or after the death of an income beneficiary or upon the expiration of a specific term of years, whichever is earlier, the grantor is treated as the owner if the specific term of years is less than 10 years (but not if the term is 10 years or longer).

(c) Where the grantor's reversionary interest in a portion of a trust is to take effect in possession or enjoyment by reason of some event other than the expiration of a specific term of years or the death of the income beneficiary, the grantor is treated as the owner of the portion if the event may reasonably be expected to occur within 10 years from the date of transfer of that portion, but he is not treated as the owner under section 673 if the event may not reasonably be expected to occur within 10 years from that date. For example, if the reversionary interest in any portion of a trust is to take effect on or after the death of the grantor (or any person other than the person to whom the income is payable) the grantor is treated under section 673 as the owner of the portion if the life expectancy of the grantor (or other person) is less than 10 years on the date of transfer of the portion, but not if the life expectancy is 10 years or longer. If the reversionary interest in any portion is to take effect on or after the death of the grantor (or any person other than the person to whom the income is payable) or upon the expiration of a specific term of years, whichever is earlier, the grantor is treated as the owner of the portion if on the date of transfer of the portion either the life expectancy of the grantor (or other person) or the specific term is less than 10 years; however, if both the life expectancy and the specific term are 10 years or longer the grantor is not treated as the owner of the portion under section 673. Similarly, if the grantor has a reversionary interest in any portion which will take effect at the death of the income beneficiary or the grantor, whichever is earlier, the grantor is not treated as an owner of the portion unless his life expectancy is less than 10 years.

(d) It is immaterial that a reversionary interest in corpus or income is subject to a contingency if the reversionary interest may, taking the contingency into consideration, reasonably be expected to take effect in possession or enjoyment within 10 years. For example, the grantor is taxable where the trust income is to be paid to the grantor's son for 3 years, and the corpus is then to be returned to the grantor if he survives that period, or to be paid to the grantor's son if he is already deceased.

(e) See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

§ 1.673(b) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; charitable beneficiaries.

SEC. 673. *Reversionary interests.* • • •

(b) *Exception where income is payable to charitable beneficiaries.* Subsection (a) shall not apply to the extent that the income of a portion of a trust in which the grantor has a reversionary interest is, under the terms of the trust, irrevocably payable for a period of at least 2 years (commencing with the date of the transfer) to a designated beneficiary, which beneficiary is of a type described in section 170 (b) (1) (A) (i), (ii), or (iii).

§ 1.673(b)–1 Income payable to charitable beneficiaries.

(a) Pursuant to section 673(b) a grantor is not treated as an owner of any portion of a trust under section 673, even though he has a reversionary interest which will take effect within 10 years, to the extent that, under the terms of the trust, the income of the portion is irrevocably payable for a period of at least 2 years (commencing with the date of the transfer) to a designated beneficiary of the type described in section 170(b)(1)(A) (i), (ii), or (iii); that is, to a church or a convention or association of churches, or to certain educational organizations or hospitals. For definitions of these terms see the regulations under section 170.

(b) Income must be irrevocably payable to a designated beneficiary for at least 2 years commencing with the date of the transfer before the benefit of section 673 (b) will apply. Thus, section 673 (b) will not apply if income of a trust is irrevocably payable to University A for 1 year and then to University B for the next year; or if income of a trust may be allocated among two or more charitable beneficiaries in the discretion of the trustee or any other person. On the other hand, section 673 (b) will apply if half the income of a trust is irrevocably payable to University A and the other half is irrevocably payable to University B for two years.

(c) Section 673 (b) applies to the period of 2 years or longer during which income is paid to a designated beneficiary of the type described in section 170 (b) (1) (A) (i), (ii), or (iii), even though the trust term is to extend beyond that period. However, the other provisions of section 673 apply to the part of the trust term, if any, that extends beyond that period. This paragraph may be illustrated by the following example:

Example. G transfers property in trust with the ordinary income payable to University C (which qualifies under section 170 (b) (1) (A) (ii)) for 3 years, and then to his son, B, for 5 years. At the expiration of the term the trust reverts to G. G is not taxed under section 673 on the trust income payable to University C for the first 3 years because of the application of section 673 (b). However, he is taxed on income for the next 5 years because he has a reversionary interest which will take effect within 10 years commencing with the date of the transfer. On the other hand, if the income were payable to University C for 3 years and then to B for 7 years so that the trust corpus would not be returned to G within 10 years, G would not be taxable under section 673 on income payable to University C and to B during any part of the term.

§ 1.673(c) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; reversionary interest taking effect at death of income beneficiary.

SEC. 673. *Reversionary interests.* • • •

(c) *Reversionary interest taking effect at death of income beneficiary.* The grantor shall not be treated under subsection (a) as the owner of any portion of a trust where his reversionary interest in such portion is not to take effect in possession or enjoyment until the death of the person or persons to whom the income therefrom is payable.

§ 1.673(c)–1 Reversionary interest after income beneficiary's death.

The subject matter of section 673(c) is covered in paragraph (b) of § 1.673 (a)–1.

§ 1.673(d) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; postponement of date specified for reacquisition.

SEC. 673. *Reversionary interests.* • • •

(d) *Postponement of date specified for reacquisition.* Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includible in the absence of such postponement.

§ 1.673(d)–1 Postponement of date specified for reacquisition.

Any postponement of the date specified for the reacquisition of possession or enjoyment of any reversionary interest is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. However, the grantor will not be treated as the owner of any por-

tion of a trust for any taxable year by reason of the foregoing sentence if he would not be so treated in the absence of any postponement. The rules contained in this section may be illustrated by the following example:

Example. G places property in trust for the benefit of his son B. Upon the expiration of 12 years or the earlier death of B the property is to be paid over to G or his estate. After the expiration of 9 years G extends the term of the trust for an additional 2 years. G is considered to have made a new transfer in trust for a term of 5 years (the remaining 3 years of the original transfer plus the 2-year extension). However, he is not treated as the owner of the trust under section 673 for the first 3 years of the new term because he would not be so treated if the term of the trust had not been extended. G is treated as the owner of the trust, however, for the remaining 2 years.

§ 1.674(a) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; power to control beneficial enjoyment.

SEC. 674. *Power to control beneficial enjoyment*—(a) *General rule.* The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

§ 1.674(a)–1 Power to control beneficial enjoyment; scope of section 674.

(a) Under section 674, the grantor is treated as the owner of a portion of trust if the grantor or a nonadverse party has a power, beyond specified limits, to dispose of the beneficial enjoyment of the income or corpus, whether the power is a fiduciary power, a power of appointment, or any other power. Section 674 (a) states in general terms that the grantor is treated as the owner in every case in which he or a nonadverse party can affect the beneficial enjoyment of a portion of a trust, the limitations being set forth as exceptions in subsections (b), (c), and (d) of section 674. These exceptions are discussed in detail in §§ 1.674 (b)–1 through 1.674 (d)–1. Certain limitations applicable to section 674 (b), (c), and (d) are set forth in § 1.674 (d)–2. Section 674 (b) describes powers which are excepted regardless of who holds them. Section 674 (c) describes additional powers of trustees which are excepted if at least half the trustees are independent, and if the grantor is not a trustee. Section 674 (d) describes a further power which is excepted if it is held by trustees other than the grantor or his spouse (if living with the grantor).

(b) In general terms the grantor is treated as the owner of a portion of a trust if he or a nonadverse party or both has a power to dispose of the beneficial enjoyment of the corpus or income unless the power is one of the following:

(1) *Miscellaneous powers over either ordinary income or corpus.* (i) A power that can only affect the beneficial enjoyment of income (including capital gains) received after a period of time such that the grantor would not be treated as an owner under section 673 if the power were a reversionary interest (section 674 (b) (2));

(ii) A testamentary power held by anyone (other than a testamentary power held by the grantor over accumulated income) (section 674 (b) (3));

(iii) A power to choose between charitable beneficiaries or to affect the manner of their enjoyment of a beneficial interest (section 674 (b) (4));

(iv) A power to allocate receipts and disbursements between income and corpus (section 674 (b) (8)).

(2) *Powers of distribution primarily affecting only one beneficiary.* (i) A power to distribute corpus to or for a current income beneficiary, if the distribution must be charged against the share of corpus from which the beneficiary may receive income (section 674 (b) (5) (B));

(ii) A power to distribute income to or for a current income beneficiary or to accumulate it either (*a*) if accumulated income must either be payable to the beneficiary from whom it was withheld or as described in paragraph (b) (6) of § 1.674 (b)–1 (section 674 (b) (6)); (*b*) if the power is to apply income to the support of a dependent of the grantor, and the income is not so applied (section 674 (b) (1)); or (*c*) if the beneficiary is under 21 or under a legal disability and accumulated income is added to corpus (section 674 (b) (7)).

(3) *Powers of distribution affecting more than one beneficiary.* A power to distribute corpus or income to or among one or more beneficiaries or to accumulate income, either (i) if the power is held by a trustee or trustees other than the grantor, at least half of whom are independent (section 674 (c)), or (ii) if the power is limited by a reasonably definite standard in the trust instrument, and in the case of a power over income, if in addition the power is held by a trustee or trustees other than the grantor and the grantor's spouse living with the grantor (section 674(b)(5)(A) and (d)). (These powers include both powers to "sprinkle" income or corpus among current beneficiaries, and powers to shift income or corpus between current beneficiaries and remaindermen; however, certain of the powers described under subparagraph (2) of this paragraph can have the latter effect incidentally.)

(c) See section 671 and §§ 1.671–2 and 1.671–3 for rules for the treatment of income, deductions, and credits when a person is treated as the owner of all or only a portion of a trust.

§ 1.674(b) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; exceptions for certain powers to control beneficial enjoyment.

SEC. 674. *Power to control beneficial enjoyment.* * * *

(b) *Exceptions for certain powers.* Subsection (a) shall not apply to the following powers regardless of by whom held:

(1) *Power to apply income to support of a dependent.* A power described in section 677 (b) to the extent that the grantor would not be subject to tax under that section.

(2) *Power affecting beneficial enjoyment only after expiration of 10-year period.* A power, the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

(3) *Power exercisable only by will.* A power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(4) *Power to allocate among charitable beneficiaries.* A power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a purpose specified in section 170 (c) (relating to definition of charitable contributions).

(5) *Power to distribute corpus.* A power to distribute corpus either—

(A) To or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or

(B) To or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(6) *Power to withhold income temporarily.* A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable—

(A) To the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or

(B) On termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

(7) *Power to withhold income during disability of a beneficiary.* A power exercisable only during—

(A) The existence of a legal disability of any current income beneficiary, or

(B) The period during which any income beneficiary shall be under the age of 21 years, to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(8) *Power to allocate between corpus and income.* A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language.

§ 1.674(b)–1 Excepted powers exercisable by any person.

(a) Paragraph (b) (1) through (8) of this section sets forth a number of powers which may be exercisable by any person without causing the grantor to be treated as an owner of a trust under section 674 (a). Further, with the exception of powers described in paragraph (b)(1) of this section, it is immaterial whether these powers are held in the capacity of trustee. It makes no difference under section 674(b) that the person holding the power is the grantor, or a related or subordinate party (with the qualifications noted in paragraph (b) (1) and (3) of this section).

(b) The exceptions referred to in paragraph (a) of this section are as follows (see, however, the limitations set forth in § 1.674 (d)–2):

(1) *Powers to apply income to support of a dependent.* Section 674 (b) (1) provides, in effect, that regardless of the general rule of section 674 (a), the income of a trust will not be considered as taxable to the grantor merely because in the discretion of any person (other than a grantor who is not acting as a trustee or cotrustee) it may be used for the support of a beneficiary whom the grantor is legally obligated to support, except to the extent that it is in fact used for that purpose. See section 677 (b) and the regulations thereunder.

(2) *Powers affecting beneficial enjoyment only after a period.* Section 674 (b)(2) provides an exception to section 674 (a) if the exercise of a power can only affect the beneficial enjoyment of the income of a trust received after a period of time which is such that a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§ 1.673 (a)–1 and 1.673 (b)–1. For example, if a trust created on January 1, 1955, provides for the payment of income to the grantor's son, and the grantor reserves the power to substitute other beneficiaries of income or corpus in lieu of his son on or after January 1, 1965, the grantor is not treated under section 674 as the owner of the trust with respect to ordinary income received before January 1, 1965. But the grantor will be treated as an owner on and after that date unless the power is relinquished. If the beginning of the period during which the grantor may substitute beneficiaries is postponed, the rules set forth in § 1.673 (d)–1 are applicable in order to determine whether the grantor should be treated as an owner during the period following the postponement.

(3) *Testamentary powers.* Under paragraph (3) of section 674 (b) a power in any person to control beneficial enjoyment exercisable only by will does not cause a grantor to be treated as an owner under section 674 (a). However, this exception does not apply to income accumulated for testamentary disposition by the grantor or to income which may be accumulated for such distribution in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. For example, if a trust instrument provides that the income is to be accumulated during the grantor's life and that the grantor may appoint the accumulated income by will, the grantor is treated as the owner of the trust. Moreover, if a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion. (See § 1.671–3.)

(4) *Powers to determine beneficial enjoyment of charitable beneficiaries.* Under paragraph (4) of section 674 (b) a power in any person to determine the beneficial enjoyment of corpus or income which is irrevocably payable (currently or in the future) for purposes specified in section 170 (c) (relating to definition of charitable contributions) will not cause the grantor to be treated as an owner under section 674 (a). For example, if a grantor creates a trust, the income of which is irrevocably payable solely to educational or other organizations that qualify under section 170 (c), he is not treated as an owner under section 674 although he retains the power to allocate the income among such organizations.

(5) *Powers to distribute corpus.* Paragraph (5) of section 674 (b) provides an exception to section 674 (a) for powers to distribute corpus, subject to certain limitations, as follows:

(i) If the power is limited by a reasonably definite standard which is set forth in the trust instrument, it may extend to corpus distributions to any beneficiary or beneficiaries or class of beneficiaries (whether income beneficiaries or remaindermen) without causing the grantor to be treated as an owner under section 674. See section 674 (b) (5) (A). It is not required that the standard consist of the needs and circumstances of the beneficiary. A clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no reasonably definite standard exists.

(ii) If the power is not limited by a reasonably definite standard set forth in the trust instrument, the exception applies only if distributions of corpus may be made solely in favor of current income beneficiaries, and any corpus distribution to the current income beneficiary must be chargeable against the proportionate part of corpus held in trust for payment of income to that beneficiary as if it constituted a separate trust (whether or not physically segregated). See section 674 (b) (5) (B).

(iii) This subparagraph may be illustrated by the following examples:

Example (1). A trust instrument provides for payment of the income to the grantor's two brothers for life, and for payment of the corpus to the grantor's nephews in equal shares. The grantor reserves the power to distribute corpus to pay medical expenses that may be incurred by his brothers or nephews. The grantor is not treated as an owner by reason of this power because section 674 (b) (5) (A) excepts a power, exercisable by any person, to invade corpus for any beneficiary, including a remainderman, if the power is limited by a reasonably definite standard which is set forth in the trust instrument. However, if the power were also exercisable in favor of a person (for example, a sister) who was not otherwise a beneficiary of the trust, section 674 (b) (5) (A) would not be applicable.

Example (2). The facts are the same as in example (1) except that the grantor reserves the power to distribute any part of the corpus to his brothers or to his nephews for their happiness. The grantor is treated as the owner of the trust. Paragraph (5) (A) of section 674 (b) is inapplicable because the power is not limited by a reasonably definite standard. Paragraph (5) (B) is inapplicable because the power to distribute corpus permits a distribution of corpus to persons other than current income beneficiaries.

Example (3). A trust instrument provides for payment of the income to the grantor's two adult sons in equal shares for 10 years, after which the corpus is to be distributed to his grandchildren in equal shares. The grantor reserves the power to pay over to each son up to one-half of the corpus during the 10-year period, but any such payment shall proportionately reduce subsequent income and corpus payments made to the son receiving the corpus. Thus, if one-half of the corpus is paid to one son, all the income from the remaining half is thereafter payable to the other son. The grantor is not treated as an owner under section 674 (a) by reason of this power because it qualifies under the exception of section 674 (b) (5) (B).

(6) *Powers to withhold income temporarily.* (i) Section 674 (b) (6) excepts a power which, in general, enables the holder merely to effect a postponement in the time when the ordinary income is enjoyed by a current income beneficiary. Specifically, there is excepted

a power to distribute or apply ordinary income to or for a current income beneficiary or to accumulate the income, if the accumulated income must ultimately be payable either:

(*a*) To the beneficiary from whom it was withheld, his estate, or his appointees (or persons designated by name, as a class, or otherwise as alternate takers in default of appointment) under a power of appointment held by the beneficiary which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate (section 674 (b) (6) (A)); or

(*b*) To the beneficiary from whom it was withheld, or if he does not survive a date of distribution which could reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified in the trust instrument (section 674 (b) (6) (A) and the flush material following); or

(*c*) On termination of the trust, or in conjunction with a distribution of corpus which is augmented by the accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument, or if any beneficiary does not survive a date of distribution which would reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified in the trust instrument (section 674 (b) (6) (B) and the flush material following).

(In the application of (*a*) of this subdivision, if the accumulated income of a trust is ultimately payable to the estate of the current income beneficiary, or is ultimately payable to his appointees, or takers in default of appointment, under a power of the type described in (*a*) of this subdivision, it need not be payable to the beneficiary from whom it was withheld under any circumstances. Furthermore, if a trust otherwise qualifies for the exception in (*a*) of this subdivision the trust income will not be considered to be taxable to the grantor under section 677 by reason of the existence of the power of appointment referred to in (*a*) of this subdivision.) In general, the exception in section 674 (b) (6) is not applicable if the power is in substance one to shift ordinary income from one beneficiary to another. Thus, a power will not qualify for this exception if ordinary income may be distributed to beneficiary A, or may be added to corpus which is ultimately payable to beneficiary B, a remainderman who is not a current income beneficiary. However, section 674 (b) (6) (B), and (*c*) of this subdivision, permit a limited power to shift ordinary income among current income beneficiaries, as illustrated in example (1) of this subparagraph.

(ii) The application of section 674 (b) (6) may be illustrated by the following examples:

Example (*1*). A trust instrument provides that the income shall be paid in equal shares to the grantor's two adult daughters but the grantor reserves the power to withhold from either beneficiary any part of that beneficiary's share of income and to add it to the corpus of the trust until the younger daughter reaches the age of 30 years. When the younger daughter reaches the age of 30, the trust is to terminate and the corpus is to be divided equally between the two daughters or their estates. Although exercise of this power may permit the shifting of accumulated income from one beneficiary to the other (since the corpus with the accumulations is to be divided equally) the power is excepted under section 674 (b) (6) (B) and subdivision (i) (*c*) of this subparagraph.

Example (*2*). The facts are the same as in example (1), except that the grantor of the trust reserves the power to distribute accumulated income to the beneficiaries in such shares as he chooses. The combined powers are not excepted by section 674 (b) (6) (B) since income accumulated pursuant to the first power is neither required to be payable only in conjunction with a corpus distribution nor required to be payable in shares specified in the trust instrument. See, however, section 674 (c) and § 1.674 (c)–1 for the effect of such a power if it is exercisable only by independent trustees.

Example (*3*). A trust provides for payment of income to the grantor's adult son with the grantor retaining the power to accumulate the income until the grantor's death, when all accumulations are to be paid to the son. If the son predeceases the grantor, all accumulations are, at the death of the grantor, to be paid to his daughter, or if she is not living, to alternate takers (which do not include the grantor's estate) in specified shares. The power is excepted under section 674 (b) (6) (A) since the date of distribution (the date of the grantor's death) may, in the usual case, reasonably be expected to occur during the beneficiary's (the son's) lifetime. It is not necessary that the accumulations be payable to the son's estate or his appointees if he should predecease the grantor for this exception to apply.

(7) *Power to withhold income during disability.* Section 674 (b) (7) provides an exception for a power which, in general, will permit ordinary income to be withheld during the legal disability of an income beneficiary or while he is under 21. Specifically, there is excepted a power, exercisable only during the existence of a legal disability of any current income beneficiary or the period during which any income beneficiary is under the age of 21 years, to distribute or apply ordinary income to or for that beneficiary or to accumulate the income and add it to corpus. To qualify under this exception it is not necessary that the income ultimately be payable to the income beneficiary from whom it was withheld, his estate, or his appointees; that is, the accumulated income may be added to corpus and ultimately distributed to others. For example, the grantor is not treated as an owner under section 674 if the income of a trust is payable to his son for life, remainder to his grandchildren, although he reserves the power to accumulate income and add it to corpus while his son is under 21.

(8) *Powers to allocate between corpus and income.* Paragraph (8) of section 674 (b) provides that a power to allocate receipts and disbursements between corpus and income, even though expressed in broad language, will not cause the grantor to be treated as an owner under the general rule of section 674 (a).

§ 1.674(c) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; exception for certain powers of independent trustees.

SEC. 674. *Power to control beneficial enjoyment.* * * *

(c) *Exception for certain powers of independent trustees.* Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor—

(1) To distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or

(2) To pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

§ 1.674(c)–1 Excepted powers exercisable only by independent trustees.

Section 674(c) provides an exception to the general rule of section 674 (a) for certain powers that are exercisable by independent trustees. This exception is in addition to those provided for under section 674 (b) which may be held by any person including an independent trustee. The powers to which section 674 (c) apply are powers (a) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, or (b) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). In order for such a power to fall within the exception of section 674 (c) it must be exercisable solely (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. (See section 672 (c) for definitions of these terms.) An example of the application of section 674 (c) is a trust whose income is payable to the grantor's three adult sons with power in an independent trustee to allocate without restriction the amounts of income to be paid to each son each year. Such a power does not cause the grantor to be treated as the owner of the trust. See, however, the limitations set forth in § 1.674 (d)–2.

§ 1.674(d) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; power to allocate income if limited by a standard.

SEC. 674. *Power to control beneficial enjoyment.* * * *

(d) *Power to allocate income if limited by a standard.* Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a reasonably definite external standard which is set forth in the trust instrument. A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

§ 1.674(d)–1 Excepted powers exercisable by any trustee other than grantor or spouse.

Section 674(d) provides an additional exception to the general rule of section 674(a) for a power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries or to, for, or within a class of beneficiaries, whether or not the conditions of section 674(b) (6) or (7) are satisfied, if the power is solely exercisable (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor or spouse living with the grantor, and if the power is limited by a reasonably definite external standard set forth in the trust instrument (see paragraph (b) (5) of § 1.674 (b)–1 with respect to what constitutes a reasonably definite standard). See, however, the limitations set forth in § 1.674 (d)–2.

§ 1.674(d)–2 Limitations on exceptions in section 674 (b), (c), and (d).

(a) *Power to remove trustee.* A power in the grantor to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) may prevent a trust from qualifying under section 674 (c) or (d). For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the trust will not qualify under section 674 (c) or (d). On the other hand if the grantor's power to remove, substitute, or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under section 674 (c) or (d), as the case may be, the power itself does not disqualify the trust. Thus, for example, a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee will not prevent a trust from qualifying under section 674 (c).

(b) *Power to add beneficiaries.* The exceptions described in section 674(b) (5), (6), and (7), (c), and (d) are not applicable if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where the action is to provide for after-born or after-adopted children. This limitation does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed to his interest in the trust (so that he would be an adverse party as to the exercise or nonexercise of that power). For example, the limitation does not apply to a power in a beneficiary of a nonspendthrift trust to assign his interest. Nor does the limitation apply to a power held by any person which would qualify as an exception under section 674 (b) (3) (relating to testamentary powers).

§ 1.675 Statutory provisions; estates and trusts; grantors and others treated as substantial owners; administrative powers.

SEC. 675. *Administrative powers.* The grantor shall be treated as the owner of any portion of a trust in respect of which—

(1) *Power to deal for less than adequate and full consideration.* A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

(2) *Power to borrow without adequate interest or security.* A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

(3) *Borrowing of the trust funds.* The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor.

(4) *General powers of administration.* A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

§ 1.675–1 Administrative powers.

(a) *General rule.* Section 675 provides in effect that the grantor is treated as the owner of any portion of a trust if under the terms of the trust instrument or circumstances attendant on its operation administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. If a grantor retains a power to amend the administrative provisions of a trust instrument which is broad enough to permit an amendment causing the grantor to be treated as the owner of a portion of the trust under section 675, he will be treated as the owner of the portion from its inception. See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

(b) *Prohibited controls.* The circumstances which cause administrative controls to be considered exercisable primarily for the benefit of the grantor are specifically described in paragraphs (1) through (4) of section 675 as follows:

(1) The existence of a power, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, which enables the grantor or any other person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income of the trust for less than adequate consideration in money or money's worth. Whether the existence of the power itself will constitute the holder an adverse party will depend on the particular circumstances.

(2) The existence of a power exercisable by the grantor or a nonadverse party, or both, which enables the grantor to borrow the corpus or income of the trust, directly or indirectly, without adequate interest or adequate security. However, this paragraph does not apply where a trustee (other than the grantor acting alone) is authorized under a general lending power to make loans to any person without regard to interest or security. A general lending power in the grantor, acting alone as trustee, under which he has power to determine interest rates and the adequacy of security is not in itself an indication that the grantor has power to borrow the corpus or income without adequate interest or security.

(3) The circumstance that the grantor has directly or indirectly borrowed the corpus or income of the trust and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence does not apply to a loan which provides for adequate interest and adequate security, if it is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor. See section 672 (c) for definition of "a related or subordinate party".

(4) The existence of certain powers of administration exercisable in a nonfiduciary capacity by any nonadverse party without the approval or consent of any person in a fiduciary capacity. The term "powers of administration" means one or more of the following powers:

(i) A power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;

(ii) A power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and

the trust are significant from the viewpoint of voting control; or

(iii) A power to reacquire the trust corpus by substituting other property of an equivalent value.

If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

(c) *Authority of trustee.* The mere fact that a power exercisable by a trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

§ 1.676(a) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; power to revoke; general rule.

SEC. 676. *Power to revoke*—(a) *General rule.* The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.

§ 1.676(a)–1 Power to revest title to portion of trust property in grantor; general rule.

If a power to revest in the grantor title to any portion of a trust is exercisable by the grantor or a nonadverse party, or both, without the approval or consent of an adverse party, the grantor is treated as the owner of that portion, except as provided in section 676(b) (relating to powers affecting beneficial enjoyment of income only after the expiration of certain periods of time). If the title to a portion of the trust will revest in the grantor upon the exercise of a power by the grantor or a nonadverse party, or both, the grantor is treated as the owner of that portion regardless of whether the power is a power to revoke, to terminate, to alter or amend, or to appoint. See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

§ 1.676(b) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; power to revoke exercisable only after a period of time.

SEC. 676. *Power to revoke.* • • •

(b) *Power affecting beneficial enjoyment only after expiration of 10-year period.* Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the expiration of such period unless the power is relinquished.

§ 1.676(b)–1 Powers exercisable only after a period of time.

Section 676(b) provides an exception to the general rule of section 676(a) when the exercise of a power can only affect the beneficial enjoyment of the income of a trust received after the expiration of a period of time which is such that a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§ 1.673(a)–1 and 1.673(b)–1. Thus, for example, a grantor is excepted from the general rule of section 676(a) with respect to ordinary income if exercise of a power to revest corpus in him cannot affect the beneficial enjoyment of the income received within 10 years after the date of transfer of that portion of the trust. It is immaterial for this purpose that the power is vested at the time of the transfer. However, the grantor is subject to the general rule of section 676(a) after the expiration of the period unless the power is relinquished. Thus, in the above example, the grantor may be treated as the owner and be taxed on all income in the eleventh and succeeding years if exercise of the power can affect beneficial enjoyment of income received in those years. If the beginning of the period during which the grantor may revest is postponed, the rules set forth in § 1.673 (d)–1 are applicable to determine whether the grantor should be treated as an owner during the period following the postponement.

§ 1.677(a) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; income for benefit of grantor; general rule.

SEC. 677. *Income for benefit of grantor*—(a) *General rule.* The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—

(1) Distributed to the grantor;

(2) Held or accumulated for future distribution to the grantor; or

(3) Applied to the payment of premiums on policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for a purpose specified in section 170 (c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

§ 1.677(a)–1 Income for benefit of grantor; general rule.

(a) Section 677 deals with situations in which a grantor of a trust is treated as the owner of a portion of the trust because he has retained an interest in the income from that portion. See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

(b) Under section 677, the grantor is treated in any taxable year as the owner of a portion of a trust (whether or not he is treated as an owner under section 674) of which the income for the taxable year or for a period not coming within the exception described in paragraph (e) of this section is, or in the discretion of the grantor or a nonadverse party, or both, (without the approval or consent of any adverse party) may be:

(1) Distributed to the grantor;

(2) Held or accumulated for future distribution to the grantor; or

(3) Applied to the payment of premiums on policies of insurance on the life of the grantor, except policies of insurance irrevocably payable for a charitable purpose specified in section 170 (c).

(c) Therefore, under the general rule of section 677 the grantor is treated as the owner of a portion of a trust if he has retained any interest which might, without the approval or consent of an adverse party, enable him to have the income from the portion, at some time, distributed to him either actually or constructively (subject to the exception described in paragraph (e) of this section). Constructive distribution to the grantor includes payment to another in obedience to his direction and payment of premiums upon policies of insurance on the grantor's life (other than policies of insurance irrevocably payable for charitable purposes). If the grantor strips himself permanently and definitively of every interest described in the first sentence of this paragraph, he is not treated as an owner under section 677 after that divesting. The word "interest" as used in the first sentence of this paragraph does not include the possibility that the grantor might receive back from a beneficiary an interest in a trust by inheritance, or as a surviving spouse under a statutory right of election or a similar right.

(d) Under section 677 a grantor is, in general, treated as owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor. However, see § 1.677 (b)–1 for special rules for trusts whose income may not be applied for the discharge of any legal obligation of the grantor other than the support or maintenance of a beneficiary whom the grantor is legally obligated to support.

(e) The last sentence of section 677 (a) provides an exception to the general rule when a discretionary right can only affect the beneficial enjoyment of the income of a trust received after a period of time which is such that a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§ 1.673 (a)–1 and 1.673 (b)–1. For example, if the or-

dinary income of a trust is payable to B for 10 years and then in the grantor's discretion income or corpus may be paid to B or to the grantor, the grantor is not treated as an owner with respect to ordinary income under section 677 during the first 10 years. He will be treated as an owner under section 677 after the expiration of the 10-year period unless the power is relinquished. If the beginning of the period during which the grantor may substitute beneficiaries is postponed, the rules set forth in § 1.673 (d)–1 are applicable in order to determine whether the grantor should be treated as an owner during the period following the postponement.

(f) However, if income is accumulated in any taxable year for future distribution to the grantor, section 677 (a) (2) treats the grantor as an owner for that taxable year. The exception set forth in the last sentence of section 677 (a) does not apply merely because the grantor must await the expiration of a period of time before he can receive or exercise discretion over previously accumulated income of the trust, even though the period is such that the grantor would not be treated as an owner under section 673 if a reversionary interest were involved. Thus, if income (including capital gains) of a trust is to be accumulated for 10 years and then will be, or at the discretion of the grantor may be, distributed to the grantor, the grantor is treated as the owner of the trust from its inception.

(g) The application of section 677 (a) may be illustrated by the following examples:

Example (1). G creates an irrevocable trust which provides that the ordinary income is to be payable to himself for life and that on his death the corpus shall be distributed to a designated charity. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671 through 677. Under the applicable local law capital gains must be applied to corpus. During the taxable year 1955 the trust has the following items of gross income and deductions:

Dividends	$5,000
Capital gain	1,000
Expenses allocable to income	200
Expenses allocable to corpus	100

Since G has a right to receive income he is treated as an owner of a portion of the trust under section 677. Accordingly, he should include the $5,000 of dividends, $200 income expense, and $100 corpus expense in the computation of his taxable income for 1955. He should not include the $1,000 capital gain since that is not attributable to the portion of the trust that he owns. See § 1.671–3. The tax consequences of the capital gain are governed by the provisions of subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Had the trust sustained a capital loss in any amount the loss would likewise not be included in the computation of G's taxable income, but would also be governed by the provisions of such subparts.

Example (2). G creates a trust whose ordinary income is payable to his adult son. Ten years from the date of transfer or on the death of his son, whichever is earlier, corpus is to revert to G. In addition, G retains a discretionary right to receive $5,000 of ordinary income each year. (Absent the exercise of this right all the ordinary income is to be distributed to his son.) G retains no other right or power which would cause him to be treated as an owner under subpart E (section 671 and following), of such part I. Under the terms of the trust instrument and applicable local law capital gains must be applied to corpus. During the taxable year 1955 the trust had the following items of income and deductions:

Dividends	$10,000
Capital gain	2,000
Expenses allocable to income	400
Expenses allocable to corpus	200

Since the capital gain is held or accumulated for future distributions to G, he is treated under section 677 (a) (2) as an owner of a portion of the trust to which the gain is attributable. Therefore, he must include the capital gain in the computation of his taxable income. (Had the trust sustained a capital loss in any amount, G would likewise include that loss in the computation of his taxable income.) In addition, because of G's discretionary right (whether exercised or not) he is treated as the owner of a portion of the trust which will permit a distribution of income to him of $5,000. Accordingly, G includes dividends of $5,208.33 and income expenses of $208.33 in computing his taxable income, determined in the following manner:

Total dividends	$10,000.00
Less: Expenses allocable to income	400.00
Distributable income of the trust	9,600.00
Portion of dividends attributable to G (5,000/9,600×$10,000)	5,208.33
Portion of income expenses attributable to G (5,000/9,600×$400)	208.33
Amount of income subject to discretionary right	5,000.00

In accordance with paragraph (c) of § 1.671–3, G also takes into account $104.17 (5,000/9,600×$200) of corpus expenses in computing his tax liability. The portion of the dividends and expenses of the trust not attributable to G are governed by the provisions of subparts A through D.

§ 1.677(b) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; trusts for support of grantor's dependents.

SEC. 677. *Income for benefit of grantor.*

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(b) *Obligations of support.* Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661 (a) and shall be taxed to the grantor under section 662.

§ 1.677(b)–1 Trusts for support.

(a) Section 677(b) provides in effect that a grantor is not treated as the owner of a trust merely because its income may in the discretion of any person except the grantor not acting as trustee or cotrustee be applied or distributed for the support or maintenance of a beneficiary, such as the wife or child of the grantor, whom the grantor is legally obligated to support. If income of the current year of the trust is actually so applied or distributed the grantor may be treated as the owner of any portion of the trust under section 677 to that extent, even though it might have been applied or distributed for other purposes.

(b) If any amount applied or distributed for the support of a beneficiary whom the grantor is legally obligated to support is paid out of corpus or out of other than income of the current year, the grantor is treated as a beneficiary of the trust, and the amount applied or distributed is considered to be an amount paid within the meaning of section 661 (a) (2), taxable to the grantor under section 662. Thus, he is subject to the other relevant portions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Accordingly, the grantor may be taxed on an accumulation distribution under subpart D (section 665 and following) of such part I. Those provisions, including the exceptions in section 665, are applied on the basis that the grantor is the beneficiary.

(c) For the purpose of determining the items of income, deduction, and credit of a trust to be included under this section in computing the grantor's tax liability, the income of the trust for the taxable year of distribution will be deemed to have been first distributed. For example, in the case of a trust reporting on the calendar year basis, a distribution made on January 1, 1956, will be deemed to have been made out of ordinary income of the trust for the calendar year 1956 to the extent of the income for that year even though the trust had received no income as of January 1, 1956. Thus, if a distribution of $10,000 is made on January 1, 1956, for the support of the grantor's dependent, the grantor will be treated as the owner of the trust for 1956 to that extent. If the trust received dividends of $5,000 and incurred expenses of $1,000 during that year but subsequent to January 1, he will take into account dividends of $5,000 and expenses of $1,000 in computing his tax liability for 1956. In addition, the grantor will be treated as a beneficiary of the trust with respect to the $6,000 ($10,000 less distributable income of $4,000 (dividends of $5,000 less expenses of $1,000)) paid out of corpus or out of other than income of the current year. See paragraph (b) of this section.

(d) The exception provided in section 677 (b) relates solely to the satisfaction of the grantor's legal obligation to support or maintain a beneficiary. Consequently, the general rule of section 677 (a) is applicable when in the discretion of the grantor or nonadverse parties income of a trust may be applied in discharge of a grantor's obligations other than his obligation of support or maintenance falling within section 677 (b). Thus, if the grantor creates a trust the income of which may in the discretion of a nonadverse party be applied in the payment of the grantor's debts, such as the payment of his rent or other household expenses, he is treated as an owner of the trust regardless of whether the income is actually so applied.

(e) The general rule of section 677 (a), and not section 677 (b), is applicable if discretion to apply or distribute income of a trust rests solely in the grantor, or in the grantor in conjunction with other persons, unless in either case the grantor has such discretion as trustee or co-trustee.

(f) The general rule of section 677 (a), and not section 677 (b), is applicable to the extent that income is required, without any discretionary determination, to be applied to the support of a beneficiary whom the grantor is legally obligated to support.

§ 1.678(a) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; person other than grantor treated as substantial owner; general rule.

SEC. 678. *Person other than grantor treated as substantial owner*—(a) *General rule.* A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) Such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) Such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

§ 1.678(a)–1 Person other than grantor treated as substantial owner; general rule.

(a) Where a person other than the grantor of a trust has a power exercisable solely by himself to vest the corpus or the income of any portion of a testamentary or inter vivos trust in himself, he is treated under section 678(a) as the owner of that portion, except as provided in section 678(b) (involving taxation of the grantor) and section 678(c) (involving an obligation of support). The holder of such a power also is treated as an owner of the trust even though he has partially released or otherwise modified the power so that he can no longer vest the corpus or income in himself, if he has retained such control of the trust as would, if retained by a grantor, subject the grantor to treatment as the owner under sections 671 to 677, inclusive. See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit where a person is treated as the owner of all or only a portion of a trust.

(b) Section 678 (a) treats a person as an owner of a trust if he has a power exercisable solely by himself to apply the income or corpus for the satisfaction of his legal obligations, other than an obligation to support a dependent (see § 1.678 (c)–1) subject to the limitation of section 678 (b). Section 678 does not apply if the power is not exercisable solely by himself. However, see § 1.662 (a)–4 for principles applicable to income of a trust which, pursuant to the terms of the trust instrument, is used to satisfy the obligations of a person other than the grantor.

§ 1.678(b) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; exception where grantor is taxable.

SEC. 678. *Person other than grantor treated as substantial owner.* * * *

(b) *Exception where grantor is taxable.* Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust is otherwise treated as the owner under sections 671 to 677, inclusive.

§ 1.678(b)–1 If grantor is treated as the owner.

Section 678(a) does not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust is treated as the owner under sections 671 to 677, inclusive.

§ 1.678(c) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; trusts for support.

SEC. 678. *Person other than grantor treated as substantial owner.* * * *

(c) *Obligations of support.* Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661 (a) and shall be taxed to the holder of the power under section 662.

§ 1.678(c)–1 Trusts for support.

(a) Section 678(a) does not apply to a power which enables the holder, in the capacity of trustee or cotrustee, to apply the income of the trust to the support or maintenance of a person whom the holder is obligated to support, except to the extent the income is so applied. See paragraphs (a), (b), and (c) of § 1.677 (b)–1 for applicable principles where any amount is applied for the support or maintenance of a person whom the holder is obligated to support.

(b) The general rule in section 678 (a) (and not the exception in section 678 (c)) is applicable in any case in which the holder of a power exercisable solely by himself is able, in any capacity other than that of trustee or cotrustee, to apply the income in discharge of his obligation of support or maintenance.

(c) Section 678 (c) is concerned with the taxability of income subject to a power described in section 678 (a). It has no application to the taxability of income which is either required to be applied pursuant to the terms of the trust instrument or is applied pursuant to a power which is not described in section 678 (a), the taxability of such income being governed by other provisions of the Code. See § 1.662(a)–4.

§ 1.678(d) Statutory provisions; estates and trusts; grantors and others treated as substantial owners; effect of renunciation or disclaimer.

SEC. 678. *Person other than grantor treated as substantial owner.* * * *

(d) *Effect of renunciation or disclaimer.* Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

§ 1.678(d)–1 Renunciation of power.

Section 678(a) does not apply to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

MISCELLANEOUS

§ 1.681(a) Statutory provisions; estates and trusts; limitation on charitable contributions deduction; unrelated business income.

SEC. 681. *Limitation on charitable deduction*—(a) *Trade or business income.* In computing the deduction allowable under section 642 (c) to a trust, no amount otherwise allowable under section 642 (c) as a deduction shall be allowed as a deduction with respect to income of the taxable year which is allocable to its unrelated business income for such year. For purposes of the preceding sentence, the term "unrelated business income" means an amount equal to the amount which, if such trust were exempt from tax under section 501 (a) by reason of section 501 (c) (3), would be computed as its unrelated business taxable income under section 512 (relating to income derived from certain business activities and from certain leases).

§ 1.681(a)–1 Limitations on charitable contributions deduction of trusts; scope of section 681.

Under section 681, the unlimited charitable contributions deduction otherwise allowable to a trust under section 642(c) is, in general, subject to percentage limitations, corresponding to those applicable to contributions by an individual under section 170(b)(1) (A) and (B), under the following circumstances;

(a) To the extent that the deduction is allocable to "unrelated business income";

(b) If the trust has engaged in a "prohibited transaction";

(c) If income is accumulated for a charitable purpose and the accumulation is (1) unreasonable, (2) substantially diverted to a noncharitable purpose, or (3) invested against the interests of the charitable beneficiaries.

Further, if the circumstance set forth in paragraph (a) or (c) of this section is applicable, the deduction is limited to income actually paid out for charitable purposes, and is not allowed for income only set aside or to be used for those purposes. If the circumstance set forth in paragraph (b) of this section is applicable, deductions for contributions to the trust may be disallowed. The provisions of section 681 are discussed in detail in §§ 1.681 (a)–2 through 1.681 (c)–1. For definition of the term "income", see section 643 (b) and § 1.643 (b)–1.

§ 1.681(a)–2 Limitation on charitable contributions deduction of trusts with trade or business income.

(a) *In general.* No charitable contributions deduction is allowable to a trust under section 642(c) for any taxable year for amounts allocable to the trust's unrelated business income for the taxable year. For the purpose of section 681 (a)

the portion of the trust ... would be allowable under section 512 (b) ... or $9,000.

the term "unrelated business income" of a trust means an amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder, if the trust were an organization exempt from tax under section 501 (a) by reason of section 501 (c) (3). For the purpose of the computation under section 512, the term "unrelated trade or business" includes a trade or business carried on by a partnership of which a trust is a member, as well as one carried on by the trust itself. While the charitable contributions deduction under section 642 (c) is entirely disallowed by section 681 (a) for amounts allocable to "unrelated business income", a partial deduction is nevertheless allowed for such amounts by the operation of section 512 (b) (11), as illustrated in paragraphs (b) and (c) of this section. This partial deduction is subject to the percentage limitations applicable to contributions by an individual under section 170 (b) (1) (A) and (B), and is not allowed for amounts set aside or to be used for charitable purposes but not actually paid out during the taxable year. Charitable contributions deductions otherwise allowable under section 170, 545 (b) (2), or 642 (c) for contributions to a trust are not disallowed solely because the trust has unrelated business income.

(b) *Determination of amounts allocable to unrelated business income.* In determining the amount for which a charitable contributions deduction would otherwise be allowable under section 642 (c) which are allocable to unrelated business income, and therefore not allowable as a deduction, the following steps are taken:

(1) There is first determined the amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder if the trust were an organization exempt from tax under section 501 (a) by reason of section 501 (c) (3), but without taking the charitable contributions deduction allowed under section 512 (b) (11).

(2) The amount for which a charitable contributions deduction would otherwise be allowable under section 642 (c) is then allocated between the amount determined in subparagraph (1) of this paragraph and any other income of the trust. Unless the facts clearly indicate to the contrary, the allocation to the amount determined in subparagraph (1) of this paragraph is made on the basis of the ratio (but not in excess of 100 percent) of the amount determined in subparagraph (1) of this paragraph to the taxable income of the trust, determined without the deduction for personal exemption under section 642 (b), the charitable contributions deduction under section 642 (c), or the deduction for distributions to beneficiaries under section 661 (a).

(3) The amount for which a charitable contributions deduction would otherwise be allowable under section 642 (c) which is allocable to unrelated business income as determined in subparagraph (2) of this paragraph, and therefore not allowable as a deduction, is the amount determined in subparagraph (2) of this paragraph reduced by the charitable contributions deduction which would be allowed under section 512 (b) (11) if the trust were an organization exempt from tax under section 501 (a) by reason of section 501 (c) (3).

(c) *Examples.* (1) The application of this section may be illustrated by the following examples, in which it is assumed that the Y charity is not a church, an educational organization, or a hospital described in section 170 (b) (1) (A) (see subparagraph (2) of this paragraph):

Example (1). The X trust has income of $50,000. There is included in this amount a net profit of $31,000 from the operation of a trade or business. The trustee is required to pay half of the trust income to A, an individual, and the balance of the trust income to the Y charity, an organization described in section 170 (c) (2). The trustee pays each beneficiary $25,000. Under these facts, the unrelated business income of the trust (computed before the charitable contributions deduction which would be allowed under section 512 (b) (11)) is $30,000 ($31,000 less the deduction of $1,000 allowed by section 512 (b) (12)). The deduction otherwise allowable under section 642 (c) is $25,000, the amount paid to the Y charity. The portion allocable to the unrelated business income (computed as prescribed in paragraph (b) (2) of this section) is $15,000, that is, an amount which bears the same ratio to $25,000 as $30,000 bears to $50,000. The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is $15,000 reduced by $6,000 (20 percent of $30,000, the charitable contributions deduction which would be allowable under section 512 (b) (11)), or $9,000.

Example (2). Assume the same facts as in example (1), except that the trustee has discretion as to the portion of the trust income to be paid to each beneficiary, and the trustee pays $40,000 to A and $10,000 to the Y charity. The deduction otherwise allowable under section 642 (c) is $10,000. The portion allocable to the unrelated business income computed as prescribed in paragraph (b) (2) of this section is $6,000, that is, an amount which bears the same ratio to $10,000 as $30,000 bears to $50,000. Since this amount does not exceed the charitable contributions deduction which would be allowable under section 512 (b) (11) ($6,000, determined as in example (1)), no portion of it is disallowed as a deduction.

Example (3). Assume the same facts as in example (1), except that the terms of the trust instrument require the trustee to pay to the Y charity the trust income, if any, derived from the trade or business, and to pay to A all the trust income derived from other sources. The trustee pays $31,000 to the Y charity and $19,000 to A. The deduction otherwise allowable under section 642 (c) is $31,000. Since the entire income from the trade or business is paid to Y charity, the amount allocable to the unrelated business income computed before the charitable contributions deduction under section 512 (b) (11) is $30,000 ($31,000 less the deduction of $1,000 allowed by section 512 (b) (12)). The amount allocable to the unrelated business income and therefore disallowed as a deduction is $24,000 ($30,000 less $6,000).

Example (4). (i) Under the terms of the trust, the trustee is required to pay half of the trust income to A, an individual, for his life, and the balance of the trust income to the Y charity, an organization described in section 170 (c) (2). Capital gains are allocable to corpus and upon A's death the trust is to terminate and the corpus is to be distributed to the Y charity. The trust has taxable income of $50,000 computed without any deduction for personal exemption, charitable contributions, or distributions. The amount of $50,000 includes $10,000 capital gains, $30,000 ($31,000 less the $1,000 deduction allowed under section 512 (b) (12)) unrelated business income (computed before the charitable contributions deduction which would be allowed under section 512 (b)(11)) and other income of $9,000. The trustee pays each beneficiary $20,000.

(ii) The deduction otherwise allowable under section 642 (c) is $30,000 ($20,000 paid to Y charity and $10,000 capital gains allocated to corpus and permanently set aside for charitable purposes). The portion allocable to the unrelated business income is $15,000, that is, an amount which bears the same ratio to $20,000 (the amount paid to Y charity) as $30,000 bears to $40,000 ($50,000 less $10,000 capital gains allocable to corpus). The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is $15,000 reduced by $6,000 (the charitable contributions deduction which would be allowable under section 512 (b) (11)), or $9,000.

(2) If, in the examples in subparagraph (1) of this paragraph, the Y charity were a church, an educational organization, or a hospital described in section 170 (b) (1) (A), then the deduction allowable under section 512 (b) (11) would be computed at a rate of 30 percent.

§ 1.681(b) Statutory provisions; estates and trusts; limitation on charitable contributions deduction; prohibited transactions.

SEC. 681. *Limitation on charitable deduction.* • • •

(b) *Operations of trusts*—(1) *Limitation on charitable, etc., deduction.* The amount otherwise allowable under section 642 (c) as a deduction shall not exceed 20 percent of the taxable income of the trust (computed without the benefit of section 642 (c) but with the benefit of section 170 (b) (1) (A)) if the trust has engaged in a prohibited transaction, as defined in paragraph (2).

(2) *Prohibited transactions.* For purposes of this subsection, the term "prohibited transaction" means any transaction after July 1, 1950, in which any trust while holding income or corpus which has been permanently set aside or is to be used exclusively for charitable or other purposes described in section 642 (c)—

(A) Lends any part of such income or corpus, without receipt of adequate security and a reasonable rate of interest, to;

(B) Pays any compensation from such income or corpus, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

(C) Makes any part of its services available on a preferential basis to;

(D) Uses such income or corpus to make any substantial purchase of securities or any other property, for more than an adequate consideration in money or money's worth, from;

(E) Sells any substantial part of the securities or other property comprising such income or corpus, for less than an adequate consideration in money or money's worth, to; or

(F) Engages in any other transaction which results in a substantial diversion of such income or corpus to;

the creator of such trust; any person who has made a substantial contribution to such trust; a member of a family (as defined in section 267 (c) (4)) of an individual who is the creator of the trust or who has made a substantial contribution to the trust; or a corporation controlled by any such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes

of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

(3) *Taxable years affected.* The amount otherwise allowable under section 642 (c) as a deduction shall be limited as provided in paragraph (1) only for taxable years after the taxable year during which the trust is notified by the Secretary that it has engaged in such transaction, unless such trust entered into such prohibited transaction with the purpose of diverting such corpus or income from the purposes described in section 642 (c), and such transaction involved a substantial part of such corpus or income.

(4) *Future charitable, etc., deductions of trusts denied deduction under paragraph (3).* If the deduction of any trust under section 642 (c) has been limited as provided in this subsection, such trust, with respect to any taxable year following the taxable year in which notice is received of limitation of deduction under section 642 (c), may, under regulations prescribed by the Secretary or his delegate, file claim for the allowance of the unlimited deduction under section 642 (c), and if the Secretary, pursuant to such regulations, is satisfied that such trust will not knowingly again engage in a prohibited transaction, the limitation provided in paragraph (1) shall not apply with respect to taxable years after the year in which such claim is filed.

(5) *Disallowance of certain charitable, etc., deductions.* No gift or bequest for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and the prevention of cruelty to children or animals), otherwise allowable as a deduction under section 170, 545 (b) (2), 642 (c), 2055, 2106 (a) (2), or 2522, shall be allowed as a deduction if made in trust and, in the taxable year of the trust in which the gift or bequest is made, the deduction allowed the trust under section 642 (c) is limited by paragraph (1). With respect to any taxable year of a trust in which such deduction has been so limited by reason of entering into a prohibited transaction with the purpose of diverting such corpus or income from the purposes described in section 642 (c), and such transaction involved a substantial part of such income or corpus, and which taxable year is the same, or before the, taxable year of the trust in which such prohibited transaction occurred, such deduction shall be disallowed the donor only if such donor or (if such donor is an individual) any member of his family (as defined in section 267 (c) (4)) was a party to such prohibited transaction.

(6) *Definition.* For purposes of this subsection, the term "gift or bequest" means any gift, contribution, bequest, devise, or legacy, or any transfer without adequate consideration.

§ 1.681(b)–1 Limitation on charitable contributions deduction of trusts engaged in prohibited transactions.

(a) *In general.* (1) If a trust has engaged in a "prohibited transaction", the charitable contributions deduction which would otherwise be allowable to the trust under section 642(c) is limited by section 681(b)(1) to 20 percent of the taxable income of the trust (computed without any charitable contributions deduction), except that an additional deduction of up to 10 percent of such taxable income is allowed for amounts actually paid to a church, an educational organization, or a hospital qualifying under section 170(b)(1)(A). There is no requirement that amounts subject to the 20-percent limitation be actually paid, if they are set aside or are to be used exclusively for charitable or other purposes so that they would be deductible under section 642(c).

(2) A "prohibited transaction" is any transaction described in section 681 (b) (2) (A) through (F), entered into after July 1, 1950, by a trust holding income or corpus permanently set aside or to be used exclusively for purposes described in section 642 (c), with (i) the creator of the trust, (ii) any substantial contributor to the trust, (iii) a member of the family (as defined in section 267 (c) (4), dealing with transactions between related taxpayers) of the creator or of a substantial contributor, or (iv) a corporation which the creator or a substantial contributor controls (within the meaning of the last portion of section 681 (b) (2)).

(3) If the trust entered into a prohibited transaction for the purpose of diverting income or corpus from the charitable or other purposes described in section 642 (c), and if the transaction involved a substantial portion of such income or corpus, the limitation of section 681 (b) (1) is applicable for the taxable year of the trust in which the transaction was commenced and for all subsequent taxable years. See examples under § 1.681 (b)–2 and the regulations under section 503. Otherwise, the limitation is only applicable for taxable years of the trust after the taxable year in which there is mailed to it, by registered or certified mail directed to the last known address of the fiduciary, a written notice by the Commissioner that it has engaged in a prohibited transaction.

(b) *Restoration of unlimited deduction.* A trust whose charitable contributions deduction under section 642 (c) has been limited by reason of the provisions of section 681 (b) (1) may file, in any taxable year following the taxable year in which notice of limitation of the deduction was issued, a claim for allowance of an unlimited deduction under section 642 (c). This claim shall be filed with the district director with whom the fiduciary is required to file the income tax return of the trust. The claim must contain or have attached to it a written declaration made under the penalties of perjury by the fiduciary (or fiduciaries) that he will not knowingly permit the trust again to engage in a prohibited transaction. If the district director is satisfied that the trust will not knowingly again engage in a prohibited transaction, he shall so notify the trust in writing. In such case the trust will be allowed an unlimited deduction under section 642 (c) (subject to the provisions of section 681) with respect to taxable years subsequent to the taxable year in which the claim is filed. Section 681 (b) (3) contemplates that a trust whose charitable contributions deduction has been limited as prescribed therein shall be subject to such limitation for at least one full taxable year.

§ 1.681(b)–2 Disallowance to donors of certain charitable, etc., deductions for gifts made in trust.

(a) *In general.* Section 681(b)(5) provides that no contribution which would otherwise be allowable as a deduction under section 170(c)(2), 545(b)(2), or 642(c) is allowable if made to a trust whose charitable contribution deduction under section 642(c) is limited, in the taxable year of the trust in which the contribution is made, under the provisions of section 681(b)(1) by reason of a prohibited transaction. However, this disallowance is applicable only to contributions made in taxable years of the trust after the taxable year in which occurred the prohibited transaction causing the trust's charitable deduction to be limited, unless—

(1) The trust has been notified in a previous taxable year (in or subsequent to the year in which the transaction was commenced) by the Commissioner, pursuant to section 681 (b) (3), that it has engaged in a prohibited transaction, or

(2) The donor of the contribution or, if the donor is an individual, any member of his family (as defined in section 267 (c) (4), dealing with transactions between related taxpayers) was a party to the prohibited transaction.

(b) *Subsection not exclusive.* The prohibited transactions enumerated in section 681 (b) (2) are in addition to and not in limitation of the restrictions contained in section 170 (c) (2), 545 (b) (2), or 642 (c). A deduction may not be allowed in view of the general provisions of those sections, even though the trust has not engaged in any of the prohibited transactions referred to in section 681 (b) (2). Thus, if the donor or the fiduciary of the trust enters into a transaction with the trust, the transaction will be closely scrutinized to ascertain whether the contribution is in fact made for the stated exempt purposes.

Example. Under the terms of an irrevocable trust established by A in 1954, the trustees were to pay half of the income of the trust to A's wife for life, and the trustees were given discretion either to accumulate the remaining half of the income for, or distribute it to, a specified charitable beneficiary. Upon the death of the wife, the entire corpus was to be paid to the named charity. The trust makes its income tax returns on the basis of the calendar year. For 1954, A takes a charitable contributions deduction for the amount of the gift in trust to the charity. In 1957, 1958, 1959, and 1960, A makes further contributions to the trust and he takes deductions for those years under section 170(c)(2). In 1958, 1959, and 1960, B (not a member of A's family) also makes contributions to the trust for its designated charitable purpose and he takes deductions for those years. In 1958, the trust commences purposely to divert to A, the creator of the trust, income and corpus which had been set aside for its charitable purpose and a substantial amount of income and corpus is so diverted by the close of the year 1959. For 1958 and subsequent years, the deduction allowed the trust under section 642(c) is limited by reason of the provisions of section 681(b)(1). Both A and B are disallowed any deduction for their charitable contributions made during 1960 to the trust. Moreover, the deductions taken by A for contributions to the trust in the years 1958 and 1959 would also be disallowed since A was a party to the prohibited transaction. If the facts and surrounding circumstances indicate that the contribution in 1957 by A was for the purpose of the prohibited transaction, then A's charitable contribution deduction for the year 1957 is also disallowed since the prohibited transaction would then have commenced with

the making of the contribution and the deduction allowed the trust under section 642 (c) would then be limited for 1957 by reason of the provisions of section 681(b)(1). The deductions taken by B for 1958 and 1959 are allowed.

§ 1.681(c) Statutory provisions; estates and trusts; limitation on charitable contributions deduction; trusts accumulating income.

SEC. 681. *Limitation on charitable deduction.* • • •

(c) *Accumulated income.* If the amounts permanently set aside, or to be used exclusively for the charitable and other purposes described in section 642 (c) during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) Are unreasonable in amount or duration in order to carry out such purposes of the trust;

(2) Are used to a substantial degree for purposes other than those prescribed in section 642 (c); or

(3) Are invested in such a manner as to jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries,

the amount otherwise allowable under section 642 (c) as a deduction shall be limited to the amount actually paid out during the taxable year and shall not exceed 20 percent of the taxable income of the trust (computed without the benefit of section 642 (c) but with the benefit of section 170 (b) (1) (A)). Paragraph (1) shall not apply to income attributable to property of a decedent dying before January 1, 1951, which is transferred under his will to a trust created by such will. In the case of a trust created by the will of a decedent dying on or after January 1, 1951, if income is required to be accumulated pursuant to the mandatory terms of the will creating the trust, paragraph (1) shall apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

§ 1.681(c)–1 Limitation on charitable contributions deduction of trusts accumulating income.

(a) *In general.* If income of a trust permanently set aside or to be used by a trust exclusively for charitable or other purposes described in section 642 (c) during the taxable year or any prior taxable year (including taxable years beginning before the effective date of section 681), is not actually paid out by the end of the taxable year, the charitable contributions deduction which would otherwise be allowable to the trust under section 642(c) for the taxable year is subject to the limitations of section 681 (c), described in paragraph (b) of this section, under the following circumstances:

(1) If accumulations of income are unreasonable. (See paragraph (c) of this section.)

(2) If income accumulated for the charitable or other purposes is used to a substantial degree for purposes other than those described in section 642 (c).

(3) If income accumulated for the charitable or other purposes is invested in such a manner as to jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries.

Whether the foregoing conditions are present in any case must be determined from all relevant facts. Such conditions may result from the use of a chain of two or more organizations, as well as from the use of only one trust. Charitable contributions deductions otherwise allowable under section 170, 545 (b) (2), or 642 (c) for contributions to a trust are not disallowed solely because the trust is subject to the provisions of section 681 (c).

(b) *Extent of limitation.* If a trust is subject to the limitations of section 681 (c) for any taxable year, the charitable deduction which would otherwise be allowable to the trust under section 642 (c) is limited to amounts actually paid out during the taxable year, and is limited to 20 percent of the taxable income of the trust (computed without any charitable deduction), except that an additional deduction of up to 10 percent of such taxable income is allowed for amounts actually paid to a church, an educational organization or a hospital qualifying under section 170 (b) (1) (A).

(c) *Unreasonable accumulations.* Accumulations of income for a charitable or other purpose described in section 642 (c) are unreasonable when more income is accumulated than is needed, or when the duration of the accumulation is longer than is needed, in order to carry out the charitable or other purpose for which the income was set aside. If the gain upon the sale or exchange of property held for the production of investment income, such as dividends, interest, and rents, is not within a reasonable time reinvested in property acquired and held in good faith for the production of investment income, the gain (except the gain upon the sale or exchange of a donated asset to the extent that the gain represents the excess of the fair market value of the asset when acquired by the trust over its substituted basis in the hands of the trust) will be considered income for the purposes of this section. The limitation of section 681 (c) (1) upon trusts unreasonably accumulating income does not apply to a testamentary trust created by a decedent dying before January 1, 1951, except to the extent that its income is attributable to property transferred to the trust by someone other than the decedent. Further, the limitation of section 681 (c) (1) does not apply to income accumulated pursuant to the mandatory terms of testamentary trusts created by decedents dying on or after January 1, 1951, except as to income accumulated during a taxable year beginning more than 21 years after the death of the last life in being designated in the trust instrument.

(d) *Restoration of unlimited deduction.* A trust whose charitable contributions deduction under section 642 (c) has been limited by reason of the provisions of section 681 (c) may file a claim for allowance of unlimited deduction under section 642 (c). This claim shall be filed with the district director with whom the fiduciary is required to file the income tax return of the trust. The claim must contain or be accompanied by information or evidence showing that the circumstances that brought about the application of section 681 (c) no longer exist, and a written declaration made under the penalties of perjury by the fiduciary (or fiduciaries) that he will not knowingly permit the trust again to violate the terms of such section. Section 681 (c) contemplates that a trust whose charitable, etc., deduction has been limited as prescribed therein shall be subject to such limitation for at least one full taxable year.

§ 1.681(d) Statutory provisions; estates and trusts; disallowance of certain charitable contributions deductions; cross reference.

SEC. 681. *Limitation on charitable deduction.* • • •

(d) *Cross reference.* For disallowance of certain charitable, etc., deductions otherwise allowable under section 642 (c), see section 503 (e).

§ 1.681(d)–1 Disallowance of certain charitable contributions deductions.

For disallowance of certain charitable contributions deductions otherwise allowable under section 642(c), see section 503 (e) and the regulations thereunder.

§ 1.682(a) Statutory provisions; estates and trusts; income of an estate or trust in case of divorce; inclusion in gross income of wife.

SEC. 682. *Income of an estate or trust in case of divorce, etc.*—(a) *Inclusion in gross income of wife.* There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance (or who is separated from her husband under a written separation agreement) the amount of the income of any trust which such wife is entitled to receive and which, except for this section, would be includible in the gross income of her husband, and such amount shall not, despite any other provision of this subtitle, be includible in the gross income of such husband. This subsection shall not apply to that part of any such income of the trust which the terms of the decree, written separation agreement, or trust instrument fix, in terms of an amount of money or a portion of such income, as a sum which is payable for the support of minor children of such husband. In case such income is less than the amount specified in the decree, agreement, or instrument, for the purpose of applying the preceding sentence, such income, to the extent of such sum payable for such support, shall be considered a payment for such support.

§ 1.682(a)–1 Income of trust in case of divorce, etc.

(a) *In general.* (1) Section 682(a) provides rules in certain cases for determining the taxability of income of trusts as between spouses who are divorced, or who are separated under a decree of separate maintenance or a written separation agreement. In such cases, the spouse actually entitled to receive payments from the trust is considered the beneficiary rather than the spouse in discharge of whose obligations the payments are made, except to the extent that the payments are specified to be for the support of the obligor spouse's minor children in the divorce or separate maintenance decree, the separation agreement or the governing trust instrument. For convenience, the beneficiary spouse will hereafter in this section and in § 1.682 (b)–1 be referred to as the "wife" and the obligor spouse from whom she is divorced or legally separated

as the "husband". (See section 7701 (a) (17).) Thus, under section 682 (a) income of a trust—

(i) Which is paid, credited, or required to be distributed to the wife in a taxable year of the wife, and

(ii) Which, except for the provisions of section 682, would be includible in the gross income of her husband,

is includible in her gross income and is not includible in his gross income.

(2) Section 682 (a) does not apply in any case to which section 71 applies. Although section 682 (a) and section 71 seemingly cover some of the same situations, there are important differences between them. Thus, section 682 (a) applies, for example, to a trust created before the divorce or separation and not in contemplation of it, while section 71 applies only if the creation of the trust or payments by a previously created trust are in discharge of an obligation imposed upon or assumed by the husband (or made specific) under the court order or decree divorcing or legally separating the husband and wife, or a written instrument incident to the divorce status or legal separation status, or a written separation agreement. If section 71 applies, it requires inclusion in the wife's income of the full amount of periodic payments received attributable to property in trust (whether or not out of trust income), while, if section 71 does not apply, section 682 (a) requires amounts paid, credited, or required to be distributed to her to be included only to the extent they are includible in the taxable income of a trust beneficiary under subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code.

(3) Section 682 (a) is designed to produce uniformity as between cases in which, without section 682 (a), the income of a so-called alimony trust would be taxable to the husband because of his continuing obligation to support his wife or former wife, and other cases in which the income of a so-called alimony trust is taxable to the wife or former wife because of the termination of the husband's obligation. Furthermore, section 682 (a) taxes trust income to the wife in all cases in which the husband would otherwise be taxed not only because of the discharge of his alimony obligation but also because of his retention of control over the trust income or corpus. Section 682 (a) applies whether the wife is the beneficiary under the terms of the trust instrument or is an assignee of a beneficiary.

(4) The application of section 682 (a) may be illustrated by the following examples, in which it is assumed that both the husband and wife make their income tax returns on a calendar year basis:

Example (1). Upon the marriage of H and W, H irrevocably transfers property in trust to pay the income to W for her life for support, maintenance, and all other expenses. Some years later, W obtains a legal separation from H under an order of court. W, relying upon the income from the trust payable to her, does not ask for any provision for her support and the decree recites that since W is adequately provided for by the trust, no further provision is being made for her. Under these facts, section 682 (a), rather than section 71, is applicable. Under the provisions of section 682 (a), the income of the trust which becomes payable to W after the order of separation is includible in her income and is deductible by the trust. No part of the income is includible in H's income or deductible by him.

Example (2). H transfers property in trust for the benefit of W, retaining the power to revoke the trust at any time. H, however, promises that if he revokes the trust he will transfer to W property in the value of $100,000. The transfer in trust and the agreement were not incident to divorce, but some years later W divorces H. The court decree is silent as to alimony and the trust. After the divorce, income of the trust which becomes payable to W is taxable to her, and is not taxable to H or deductible by him. If H later terminates the trust and transfers $100,000 of property to W, the $100,000 is not income to W nor deductible by H.

(b) *Alimony trust income designated for support of minor children.* Section 682 (a) does not require the inclusion in the wife's income of trust income which the terms of the divorce or separate maintenance decree, separation agreement, or trust instrument fix in terms of an amount of money or a portion of the income as a sum which is payable for the support of minor children of the husband. The portion of the income which is payable for the support of the minor children is includible in the husband's income. If in such a case trust income fixed in terms of an amount of money is to be paid but a lesser amount becomes payable, the trust income is considered to be payable for the support of the husband's minor children to the extent of the sum which would be payable for their support out of the originally specified amount of trust income. This rule is similar to that provided in the case of periodic payments under section 71. See § 1.71–1.

§ 1.682(b) Statutory provisions; estates and trusts; income of an estate or trust in case of divorce; wife considered a beneficiary.

SEC. 682. *Income of an estate or trust in case of divorce, etc.* * * *

(b) *Wife considered a beneficiary.* For purposes of computing the taxable income of the estate or trust and the taxable income of a wife to whom subsection (a) or section 71 applies, such wife shall be considered as the beneficiary specified in this part. A periodic payment under section 71 to any portion of which this part applies shall be included in the gross income of the beneficiary in the taxable year in which under this part such portion is required to be included.

§ 1.682(b)–1 Application of trust rules to alimony payments.

(a) For the purpose of the application of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code, the wife described in section 682 or section 71 who is entitled to receive payments attributable to property in trust is considered a beneficiary of the trust, whether or not the payments are made for the benefit of the husband in discharge of his obligations.

(b) A periodic payment includible in the wife's gross income under section 71 attributable to property in trust is included in full in her gross income in her taxable year in which any part is required to be included under section 652 or 662. Assume, for example, in a case in which both the wife and the trust file income tax returns on the calendar year basis, that an annuity of $5,000 is to be paid to the wife by the trustee every December 31 (out of trust income if possible and, if not, out of corpus) pursuant to the terms of a divorce decree. Of the $5,000 distributable on December 31, 1954, $4,000 is payable out of income and $1,000 out of corpus. The actual distribution is made in 1955. Although the periodic payment is received by the wife in 1955, since under section 662 the $4,000 income distributable on December 31, 1954, is to be included in the wife's income for 1954, the $1,000 payment out of corpus is also to be included in her income for 1954.

§ 1.682(c) Statutory provisions; estates and trusts; income of an estate or trust in case of divorce; definitions of "husband" and "wife".

SEC. 682. *Income of an estate or trust in case of divorce, etc.* * * *

(c) *Cross reference.* For definitions of "husband" and "wife", as used in this section, see section 7701 (a) (17).

§ 1.682(c)–1 Definitions.

For definitions of the terms "husband" and "wife" as used in section 682, see section 7701(a)(17) and the regulations thereunder.

§ 1.683 Statutory provisions; estates and trusts; applicability of provisions.

SEC. 683. *Applicability of provisions*—(a) *General rule.* This part shall apply only to taxable years beginning after December 31, 1953, and ending after the date of the enactment of this title.

(b) *Exceptions.* In the case of any beneficiary of an estate or trust—

(1) This part shall not apply to any amount paid, credited, or to be distributed by the estate or trust in any taxable year of such estate or trust to which this part does not apply, and

(2) The Internal Revenue Code of 1939 shall apply for purposes of determining the amount includible in the gross income of the beneficiary.

To the extent that any amount paid, credited, or to be distributed by an estate or trust in the first taxable year of such estate or trust to which this part applies would be treated, if the Internal Revenue Code of 1939 were applicable, as paid, credited, or to be distributed on the last day of the preceding taxable year, such amount shall not be taken into account for purposes of this part but shall be taken into account as provided in the Internal Revenue Code of 1939.

§ 1.683–1 Applicability of provisions; general rule.

Part I (section 641 and following), subchapter J, chapter 1 of the Code, applies to estates and trusts and to beneficiaries only with respect to taxable years which begin after December 31, 1953, and end after August 16, 1954, the date of enactment of the Internal Revenue Code of 1954. In the case of an estate or trust, the date on which a trust is created or amended or on which an estate commences, and the taxable years of beneficiaries, grantors, or decedents concerned are immaterial. This provision applies equally to taxable years of normal and of abbreviated length.

§ 1.683–2 Exceptions.

(a) In the case of any beneficiary of an estate or trust, sections 641 through 682 do not apply to any amount paid, credited, or to be distributed by an estate or trust in any taxable year of the estate or trust which begins before January 1, 1954, or which ends before August 17, 1954. Whether an amount so paid, credited, or to be distributed is to be included in the gross income of a beneficiary is determined with reference to the Internal Revenue Code of 1939. Thus, if a trust in its fiscal year ending June 30, 1954, distributed its current income to a beneficiary on June 30, 1954, the extent to which the distribution is includible in the beneficiary's gross income for his taxable year (the calendar year 1954) and the character of such income will be determined under the Internal Revenue Code of 1939. The Internal Revenue Code of 1954, however, determines the beneficiary's tax liability for a taxable year of the beneficiary to which such Code applies, with respect even to gross income of the beneficiary determined under the Internal Revenue Code of 1939 in accordance with this paragraph. Accordingly, the beneficiary is allowed credits and deductions pursuant to the Internal Revenue Code of 1954 for a taxable year governed by the Internal Revenue Code of 1954. See subparagraph (ii) of example (1) in paragraph (c) of this section.

(b) For purposes of determining the time of receipt of dividends under sections 34 and 116, the dividends paid, credited, or to be distributed to a beneficiary are deemed to have been received by the beneficiary ratably on the same dates that the dividends were received by the estate or trust.

(c) The application of this section may be illustrated by the following examples:

Example (1). (i) A trust, reporting on the fiscal year basis, receives in its taxable year ending November 30, 1954, dividends on December 3, 1953, and April 3, July 5, and October 4, 1954. It distributes the dividends to A, its sole beneficiary (who reports on the calendar year basis) on November 30, 1954. Since the trust has received dividends in a taxable year ending after July 31, 1954, it will receive a dividend credit under section 34 with respect to dividends received which otherwise qualify under that section, in this case dividends received on October 4, 1954 (i. e., received after July 31, 1954). See section 7851 (a) (1) (C). This credit, however, is reduced to the extent the dividends are allocable to the beneficiary as a result of income being paid, credited, or required to be distributed to him. The trust will also be permitted the dividend exclusion under section 116, since it received its dividends in a taxable year ending after July 31, 1954.

(ii) A is entitled to the section 34 credit with respect to the portion of the October 4, 1954, dividends which is distributed to him even though the determination of whether the amount distributed to him is includible in his gross income is made under the Internal Revenue Code of 1939. The credit allowable to the trust is reduced proportionately to the extent A is deemed to have received the October 4 dividends. A is not entitled to a credit with respect to the dividends received by the trust on December 3, 1953, and April 3, and July 5, 1954, because, although he receives after July 31, 1954, the distribution resulting from the trust's receipt of dividends, he is deemed to have received the dividends ratably with the trust on dates prior to July 31, 1954. In determining the exclusion under section 116 to which he is entitled, all the dividends received by the trust in 1954 and distributed to him are aggregated with any other dividends received by him in 1954, since he is deemed to have received such dividends in 1954 and therefore within a taxable year ending after July 31, 1954. He is not, however, entitled to the exclusion for the dividends received by the trust in December 1953.

Example (2). (i) A simple trust reports on the basis of a fiscal year ending July 31. It receives dividends on October 3, 1953, and January 4, April 3, and July 5, 1954. It distributes the dividends to A, its sole beneficiary, on September 1, 1954. The trust, receiving dividends in a taxable year ending prior to August 17, 1954, is entitled neither to the dividend received credit under section 34 nor the dividend exclusion under section 116.

(ii) A (reporting on the calendar year basis) is not entitled to the section 34 credit, because, although he receives after July 31, 1954, the distribution resulting from the trust's receipt of dividends, he is deemed to have received the dividends ratably with the trust, that is, on October 3, 1953, and January 4, April 3, and July 5, 1954. He is, however, entitled to the section 116 exclusion with respect to the dividends received by the trust in 1954 (along with other dividends received by him in 1954) and distributed to him, since he is deemed to have received such dividends on January 4, April 3, and July 5, 1954, each a date in his taxable year ending after July 31, 1954. He is entitled to no exclusion for the dividends received by the trust on October 3, 1953, since he is deemed to receive the resulting distribution on the same date, which falls within a taxable year of his which ends before August 1, 1954, although he is required to include the October 1953 dividends in his 1954 income. See section 164 of the Internal Revenue Code of 1939.

Example (3). A simple trust on a fiscal year ending July 31, 1954, receives dividends August 5 and November 4, 1953. It distributes the dividends to A, its sole beneficiary (who is on a calendar year basis), on September 1, 1954. Neither the trust nor A is entitled to a credit under section 34 or an exclusion under section 116.

§ 1.683–3 Application of the 65-day rule of the Internal Revenue Code of 1939.

If an amount is paid, credited, or to be distributed in the first 65 days of the first taxable year of an estate or trust (heretofore subject to the provisions of the Internal Revenue Code of 1939) to which the Internal Revenue Code of 1954 applies and the amount would be treated, if the Internal Revenue Code of 1939 were applicable, as if paid, credited, or to be distributed on the last day of the preceding taxable year, sections 641 through 682 do not apply to the amount. The amount so paid, credited, or to be distributed is taken into account as provided in the Internal Revenue Code of 1939. See 26 CFR (1939) 39.162–2 (c) and (d) (Regulations 118).

INCOME IN RESPECT OF DECEDENTS

§ 1.691(a) Statutory provisions; recipients of income in respect of decedents; inclusion in gross income.

SEC. 691. *Recipients of income in respect of decedents*—(a) *Inclusion in gross income*—(1) *General rule.* The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of:

(A) The estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(B) The person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(C) The person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

(2) *Income in case of sale, etc.* If a right, described in paragraph (1), to receive an amount is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value. For purposes of this paragraph, the term "transfer" includes sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

(3) *Character of income determined by reference to decedent.* The right, described in paragraph (1), to receive an amount shall be treated, in the hands of the estate of the decedent or any person who acquired such right by reason of the death of the decedent, or by bequest, devise, or inheritance from the decedent, as if it had been acquired by the estate or such person in the transaction in which the right to receive the income was originally derived and the amount includible in gross income under paragraph (1) or (2) shall be considered in the hands of the estate or such person to have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount.

(4) *Installment obligations acquired from decedent.* In the case of an installment obligation received by a decedent on the sale or other disposition of property, the income from which was properly reportable by the decedent on the installment basis under section 453, if such obligation is acquired by the decedent's estate from the decedent or by any person by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent—

(A) An amount equal to the excess of the face amount of such obligation over the basis of the obligation in the hands of the decedent (determined under section 453 (d)) shall, for the purpose of paragraph (1), be considered as an item of gross income in respect of the decedent; and

(B) Such obligation shall, for purposes of paragraphs (2) and (3), be considered a right to receive an item of gross income in respect of the decendent, but the amount includible in gross income under paragraph (2) shall be reduced by an amount equal to the basis of the obligation in the hands of the decedent (determined under section 453 (d)).

§ 1.691(a)–1 Income in respect of a decedent.

(a) *Scope of section 691.* In general, the regulations under section 691 cover: (1) The provisions requiring that amounts which are not includible in gross income for the decedent's last taxable year or for a prior taxable year be included in the gross income of the estate or persons receiving such income to the extent that such amounts constitute "income in respect of a decedent"; (2) the taxable effect of a transfer of the right to such income; (3) the treatment of certain deductions and credit in respect of a decedent which are not allowable to the decedent for the taxable period ending with his death or for a prior taxable year; (4) the allowance to a recipient of income in respect of a decedent of a deduction for estate taxes attributable to the inclusion of the value of the right to such income in the decedent's estate; and (5) special provisions with respect to installment obligations acquired from a decedent and with respect to the allowance of a deduction for estate taxes to a surviving annuitant under a joint and survivor annuity contract.

(b) *General definition.* In general, the term "income in respect of a decedent" refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. See the regulations under section 451. Thus, the term includes—

(1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;

(2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and

(3) Income to which the decedent had a contingent claim at the time of his death.

See sections 736 and 753 and the regulations thereunder for "income in respect of a decedent" in the case of a deceased partner.

(c) *Prior decedent.* The term "income in respect of a decedent" also includes the amount of all items of gross income in respect of a prior decedent, if (1) the right to receive such amount was acquired by the decedent by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent and if (2) the amount of gross income in respect of the prior decedent was not properly includible in computing the decedent's taxable income for the taxable year ending with the date of his death or for a previous taxable year. See example (2) of paragraph (b) of § 1.691(a)–2.

(d) *Items excluded from gross income.* Section 691 applies only to the amount of items of gross income in respect of a decedent, and items which are excluded from gross income under subtitle A of the Code are not within the provisions of section 691.

(e) *Cross reference.* For items deemed to be income in respect of a decedent for purposes of the deduction for estate taxes provided by section 691 (c), see paragraph (c) of § 1.691(c)–1.

§ 1.691(a)–2 Inclusion in gross income by recipients.

(a) Under section 691(a)(1), income in respect of a decedent shall be included in the gross income, for the taxable year when received, of—

(1) The estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(2) The person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(3) The person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

These amounts are included in the income of the estate or of such persons when received by them whether or not they report income by use of the cash receipts and disbursements method.

(b) The application of paragraph (a) of this section may be illustrated by the following examples, in each of which it is assumed that the decedent kept his books by use of the cash receipts and disbursements method.

Example (1). The decedent was entitled at the date of his death to a large salary payment to be made in equal annual installments over five years. His estate, after collecting two installments, distributed the right to the remaining installment payments to the residuary legatee of the estate. The estate must include in its gross income the two installments received by it, and the legatee must include in his gross income each of the three installments received by him.

Example (2). A widow acquired, by bequest from her husband, the right to receive renewal commissions on life insurance sold by him in his lifetime, which commissions were payable over a period of years. The widow died before having received all of such commissions, and her son inherited the right to receive the rest of the commissions. The commissions received by the widow were includible in her gross income. The commissions received by the son were not includible in the widow's gross income but must be included in the gross income of the son.

Example (3). The decedent owned a Series E United States savings bond, with his wife as co-owner or beneficiary, but died before the payment of such bond. The entire amount of interest accruing on the bond and not includible in income by the decedent, not just the amount accruing after the death of the decedent, would be treated as income to his wife when the bond is paid.

Example (4). A, prior to his death, acquired 10,000 shares of the capital stock of the X Corporation at a cost of $100 per share. During his lifetime, A had entered into an agreement with X Corporation whereby X Corporation agreed to purchase and the decedent agreed that his executor would sell the 10,000 shares of X Corporation stock owned by him at the book value of the stock at the date of A's death. Upon A's death, the shares are sold by A's executor for $500 a share pursuant to the agreement. Since the sale of stock is consummated after A's death, there is no income in respect of a decedent with respect to the appreciation in value of A's stock to the date of his death. If, in this example, A had in fact sold the stock during his lifetime but payment had not been received before his death, any gain on the sale would constitute income in respect of a decedent when the proceeds were received.

Example (5). (1) A owned and operated an apple orchard. During his lifetime, A sold and delivered 1,000 bushels of apples to X, a canning factory, but did not receive payment before his death. A also entered into negotiations to sell 3,000 bushels of apples to Y, a canning factory, but did not complete the sale before his death. After A's death, the executor received payment from X. He also completed the sale to Y and transferred to Y 1,200 bushels of apples on hand at A's death and harvested and transferred an additional 1,800 bushels. The gain from the sale of apples by A to X constitutes income in respect of a decedent when received. On the other hand, the gain from the sale of apples by the executor to Y does not.

(2) Assume that, instead of the transaction entered into with Y, A had disposed of the 1,200 bushels of harvested apples by delivering them to Z, a cooperative association, for processing and sale. Each year the association commingles the fruit received from all of its members into a pool and assigns to each member a percentage interest in the pool based on the fruit delivered by him. After the fruit is processed and the products are sold, the association distributes the net proceeds from the pool to its members in proportion to their interests in the pool. After A's death, the association made distributions to the executor with respect to A's share of the proceeds from the pool in which A had an interest. Under such circumstances, the proceeds from the disposition of the 1,200 bushels of apples constitute income in respect of a decedent.

§ 1.691(a)–3 Character of gross income.

(a) The right to receive an amount of income in respect of a decedent shall be treated in the hands of the estate, or by the person entitled to receive such amount by bequest, devise, or inheritance from the decedent or by reason of his death, as if it had been acquired in the transaction by which the decedent (or a prior decedent) acquired such right, and shall be considered as having the same character it would have had if the decedent (or a prior decedent) had lived and received such amount. The provisions of section 1014(a), relating to the basis of property acquired from a decedent, do not apply to these amounts in the hands of the estate and such persons. See section 1014(c).

(b) The application of paragraph (a) of this section may be illustrated by the following:

(1) If the income would have been capital gain to the decedent, if he had lived and had received it, from the sale of property held for more than 6 months, the income, when received, shall be treated in the hands of the estate or of such person as capital gain from the sale of the property, held for more than 6 months, in the same manner as if such person had held the property for the period the decedent held it, and had made the sale.

(2) If the income is interest on United States obligations which were owned by the decedent, such income shall be treated as interest on United States obligations in the hands of the person receiving it, for the purpose of determin-

ing the credit provided by section 35, as if such person had owned the obligations with respect to which such interest is paid.

(3) If the amounts received would be subject to special treatment under part I (section 1301 and following), subchapter Q, chapter 1 of the Code, relating to income attributable to several taxable years, if the decedent had lived and included such amounts in his gross income, such sections apply with respect to the recipient of the income.

(4) The provisions of sections 632 and 1347, relating to the tax attributable to the sale of certain oil or gas property and to certain claims against the United States, apply to any amount included in gross income, the right to which was obtained by the decedent by a sale or claim within the provisions of those sections.

§ 1.691(a)–4 Transfer of right to income in respect of a decedent.

(a) Section 691(a)(2) provides the rules governing the treatment of income in respect of a decedent (or a prior decedent) in the event a right to receive such income is transferred by the estate or person entitled thereto by bequest, devise, or inheritance, or by reason of the death of the decedent. In general, the transferor must include in his gross income for the taxable period in which the transfer occurs the amount of the consideration, if any, received for the right or the fair market value of the right at the time of the transfer, whichever is greater. Thus, upon a sale of such right by the estate or person entitled to receive it, the fair market value of the right or the amount received upon the sale, whichever is greater, is included in the gross income of the vendor. Similarly, if such right is disposed of by gift, the fair market value of the right at the time of the gift must be included in the gross income of the donor. In the case of a satisfaction of an installment obligation at other than face value, which is likewise considered a transfer under section 691(a)(2), see § 1.691(a)–5.

(b) If the estate of a decedent or any person transmits the right to income in respect of a decedent to another who would be required by section 691 (a) (1) to include such income when received in his gross income, only the transferee will include such income when received in his gross income. In this situation, a transfer within the meaning of section 691 (a) (2) has not occurred. This paragraph may be illustrated by the following:

(1) If a person entitled to income in respect of a decedent dies before receiving such income, only his estate or other person entitled to such income by bequest, devise, or inheritance from the latter decedent, or by reason of the death of the latter decedent, must include such amount in gross income when received.

(2) If a right to income in respect of a decedent is transferred by an estate to a specific or residuary legatee, only the specific or residuary legatee must include such income in gross income when received.

(3) If a trust to which is bequeathed a right of a decedent to certain payments of income terminates and transfers the right to a beneficiary, only the beneficiary must include such income in gross income when received.

If the transferee described in subparagraphs (1), (2), and (3) of this paragraph transfers his right to receive the amounts in the manner described in paragraph (a) of this section, the principles contained in paragraph (a) are applied to such transfer. On the other hand, if the transferee transmits his right in the manner described in this paragraph, the principles of this paragraph are again applied to such transfer.

§ 1.691(a)–5 Installment obligations acquired from decedent.

(a) Section 691(a)(4) has reference to an installment obligation which remains uncollected by a decedent (or a prior decedent) and which was originally acquired in a transaction the income from which was properly reportable by the decedent on the installment method under section 453. Under the provisions of section 691(a)(4), an amount equal to the excess of the face value of the obligation over its basis in the hands of the decedent (determined under section 453 (d)(2) and the regulations thereunder) shall be considered an amount of income in respect of a decedent and shall be treated as such. The decedent's estate (or the person entitled to receive such income by bequest, devise, or inheritance from the decedent or by reason of the decedent's death) shall include in its gross income when received the same proportion of any payment in satisfaction of such obligations as would be returnable as income by the decedent if he had lived and received such payment. No gain on account of the transmission of such obligations by the decedent's death is required to be reported as income in the return of the decedent for the year of his death.

(b) If an installment obligation described in paragraph (a) of this section is transferred within the meaning of section 691 (a) (2) and paragraph (a) of § 1.691 (a)–4, the entire installment obligation transferred shall be considered a right to income in respect of a decedent but the amount includible in the gross income of the transferor shall be reduced by an amount equal to the basis of the obligation in the hands of the decedent (determined under section 453 (d) (2) and the regulations thereunder) adjusted, however, to take into account the receipt of any installment payments after the decedent's death and before such transfer. Thus, the amount includible in the gross income of the transferor shall be the fair market value of such obligation at the time of the transfer or the consideration received for the transfer of the installment obligation, whichever is greater, reduced by the basis of the obligation as described in the preceding sentence. For purposes of this paragraph, the term "transfer" in section 691 (a) (2) and paragraph (a) of § 1.691 (a)–4 includes the satisfaction of an installment obligation at other than face value.

(c) The application of this section may be illustrated by the following example:

Example. An heir of a decedent is entitled to collect an installment obligation with a face value of $100, a fair market value of $80, and a basis in the hands of the decedent of $60. If the heir collects the obligation at face value, the excess of the amount collected over the basis is considered income in respect of a decedent and includible in the gross income of the heir under section 691 (a) (1). In this case, the amount includible would be $40 ($100 less $60). If the heir collects the obligation at $90, an amount other than face value, the entire obligation is considered a right to receive income in respect of a decedent but the amount ordinarily required to be included in the heir's gross income under section 691 (a) (2) (namely, the consideration received in satisfaction of the installment obligation or its fair market value, whichever is greater) shall be reduced by the amount of the basis of the obligation in the hands of the decedent. In this case, the amount includible would be $30 ($90 less $60).

§ 1.691(b) Statutory provisions; recipients of income in respect of decedents; allowance of deductions and credit.

SEC. 691. *Recipients of income in respect of decedents.* * * *

(b) *Allowance of deductions and credit.* The amount of any deduction specified in section 162, 163, 164, 212, or 611 (relating to deductions for expenses, interest, taxes, and depletion) or credit specified in section 33 (relating to foreign tax credit), in respect of a decedent which is not properly allowable to the decedent in respect of the taxable period in which falls the date of his death, or a prior period, shall be allowed:

(1) *Expenses, interest, and taxes.* In the case of a deduction specified in section 162, 163, 164, or 212 and a credit specified in section 33, in the taxable year when paid—

(A) To the estate of the decedent; except that

(B) If the estate of the decedent is not liable to discharge the obligation to which the deduction or credit relates, to the person who, by reason of the death of the decedent or by bequest, devise, or inheritance acquires, subject to such obligation, from the decedent an interest in property of the decedent.

(2) *Depletion.* In the case of the deduction specified in section 611, to the person described in subsection (a) (1) (A), (B), or (C) who, in the manner described therein, receives the income to which the deduction relates, in the taxable year when such income is received.

§ 1.691(b)–1 Allowance of deductions and credit in respect of decedents.

(a) Under section 691(b) the expenses, interest, and taxes described in sections 162, 163, 164, and 212 for which the decedent (or a prior decedent) was liable, which were not properly allowable as a deduction in his last taxable year or any prior taxable year, are allowed when paid—

(1) As a deduction by the estate; or

(2) If the estate was not liable to pay such obligation, as a deduction by the person who by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent acquires, subject to such obligation, an interest in property of the decedent (or the prior decedent).

Similar treatment is given to the foreign tax credit provided by section 33. For the purposes of subparagraph (2) of this

paragraph, the right to receive an amount of gross income in respect of a decedent is considered property of the decedent; on the other hand, it is not necessary for a person, otherwise within the provisions of subparagraph (2) of this paragraph, to receive the right to any income in respect of a decedent. Thus, an heir who receives a right to income in respect of a decedent (by reason of the death of the decedent) subject to an income tax imposed by a foreign country during the decedent's life, which tax must be satisfied out of such income, is entitled to the credit provided by section 33 when he pays the tax. If a decedent who reported income by use of the cash receipts and disbursements method owned real property on which accrued taxes had become a lien, and if such property passed directly to the heir of the decedent in a jurisdiction in which real property does not become a part of a decedent's estate, the heir, upon paying such taxes, may taken the same deduction under section 164 that would be allowed to the decedent if, while alive, he had made such payment.

(b) The deduction for percentage depletion is allowable only to the person (described in section 691 (a) (1)) who receives the income in respect of the decedent to which the deduction relates, whether or not such person receives the property from which such income is derived. Thus, an heir who (by reason of the decedent's death) receives income derived from sales of units of mineral by the decedent (who reported income by use of the cash receipts and disbursements method) shall be allowed the deduction for percentage depletion, computed on the gross income from such number of units as if the heir had the same economic interest in the property as the decedent. Such heir need not also receive any interest in the mineral property other than such income. If the decedent did not compute his deduction for depletion on the basis of percentage depletion, any deduction for depletion to which the decedent was entitled at the date of his death would be allowable in computing his taxable income for his last taxable year, and there can be no deduction in respect of the decedent by any other person for such depletion.

§ 1.691(c) Statutory provisions; recipients of income in respect of decedents; deduction for estate tax.

SEC. 691. *Recipients of income in respect of decedents.* * * *

(c) *Deduction for estate tax*—(1) *Allowance of deduction*—(A) *General rule.* A person who includes an amount in gross income under subsection (a) shall be allowed, for the same taxable year, as a deduction an amount which bears the same ratio to the estate tax attributable to the net value for estate tax purposes of all the items described in subsection (a) (1) as the value for estate tax purposes of the items of gross income or portions thereof in respect of which such person included the amount in gross income (or the amount included in gross income, whichever is lower) bears to the value for estate tax purposes of all the items described in subsection (a) (1).

(B) *Estates and trusts.* In the case of an estate or trust, the amount allowed as a deduction under subparagraph (A) shall be computed by excluding from the gross income of the estate or trust the portion (if any) of the items described in subsection (a) (1) which is properly paid, credited, or to be distributed to the beneficiaries during the taxable year. This subparagraph shall apply to the same taxable years, and to the same extent, as is provided in section 663.

(2) *Method of computing deduction.* For purposes of paragraph (1)—

(A) The term "estate tax" means the tax imposed on the estate of the decedent or any prior decedent under section 2001 or 2101, reduced by the credits against such tax.

(B) The net value for estate tax purposes of all the items described in subsection (a) (1) shall be the excess of the value for estate tax purposes of all the items described in subsection (a) (1) over the deductions from the gross estate in respect of claims which represent the deductions and credit described in subsection (b). Such net value shall be determined with regard to the provisions of section 421 (d) (6) (B), relating to the deduction for estate tax with respect to restricted stock options.

(C) The estate tax attributable to such net value shall be an amount equal to the excess of the estate tax over the estate tax computed without including in the gross estate such net value.

§ 1.691(c)–1 Deduction for estate tax attributable to income in respect of a decedent.

(a) *In general.* A person who is required to include in gross income for any taxable year an amount of income in respect of a decedent may deduct for the same taxable year that portion of the estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount. The deduction is determined as follows:

(1) Ascertain the net value in the decedent's estate of the items which are included under section 691 in computing gross income. This is the excess of the value included in the gross estate on account of the items of gross income in respect of the decedent (see § 1.691 (a)–1 and paragraph (c) of this section) over the deductions from the gross estate for claims which represent the deductions and credit in respect of the decedent (see § 1.691 (b)–1). But see section 691 (d) and paragraph (b) of § 1.691 (d)–1 for computation of the special value of a survivor's annuity to be used in computing the net value for estate tax purposes in cases involving joint and survivor annuities.

(2) Ascertain the portion of the estate tax attributable to the inclusion in the gross estate of such net value. This is the excess of the estate tax over the estate tax computed without including such net value in the gross estate. In computing the estate tax without including such net value in the gross estate, any estate tax deduction (such as the marital deduction) which may be based upon the gross estate shall be recomputed so as to take into account the exclusion of such net value from the gross estate. See example (2), paragraph (e) of § 1.691 (d)–1.

For purposes of this section, the term "estate tax" means the tax imposed under section 2001 or 2101 (or the corresponding provisions of the Internal Revenue Code of 1939), reduced by the credits against such tax. Each person including in gross income an amount of income in respect of a decedent may deduct as his share of the portion of the estate tax (computed under subparagraph (2) of this paragraph) an amount which bears the same ratio to such portion as the value in the gross estate of the right to the income included by such person in gross income (or the amount included in gross income if lower) bears to the value in the gross estate of all the items of gross income in respect of the decedent.

(b) *Prior decedent.* If a person is required to include in gross income an amount of income in respect of a prior decedent, such person may deduct for the same taxable year that portion of the estate tax imposed upon the prior decedent's estate which is attributable to the inclusion in the prior decedent's estate of the value of the right to receive such amount. This deduction is computed in the same manner as provided in paragraph (a) of this section and is in addition to the deduction for estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount.

(c) *Amounts deemed to be income in respect of a decedent.* For purposes of allowing the deduction under section 691 (c), the following items are also considered to be income in respect of a decedent under section 691 (a):

(1) The value for estate tax purposes of restricted stock options in respect of which amounts are includible in gross income under section 421 (b). See section 421 (d) (6).

(2) Amounts received by a surviving annuitant during his life expectancy period as an annuity under a joint and survivor annuity contract to the extent included in gross income under section 72. See section 691 (d).

(d) *Examples.* Paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). X, an attorney who kept his books by use of the cash receipts and disbursements method, was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued in his estate at $1,000, and to accrued bond interest, which was valued in his estate at $500. In all, $1,500 was included in his gross estate in respect of income described in section 691 (a) (1). There were deducted as claims against his estate $150 for business expenses for which his estate was liable and $50 for taxes accrued on certain property which he owned. In all, $200 was deducted for claims which represent amounts described in section 691 (b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was $185,000 and, considering deductions of $15,000 and an exemption of $60,000, his taxable estate amounted to $110,000. The estate tax on this amount is $23,700 from which is subtracted a $75 credit for State death taxes leaving an estate tax liability of $23,625. In the year following the closing of X's estate, the fee in the amount of $1,200 was collected by X's son, who was the sole bene-

ficiary of the estate. This amount was included under section 691 (a) (1) (C) in the son's gross income. The son may deduct, in computing his taxable income for such year, $260 on account of the estate tax attributable to such income, computed as follows:

(1) (i) Value of income described in section 691 (a) (1) included in computing gross estate	$1,500
(ii) Deductions in computing gross estate for claims representing deductions described in section 691 (b)	200
(iii) Net value of items described in section 691 (a) (1)	1,300
(2) (i) Estate tax	23,625
(ii) Less: Estate tax computed without including $1,300 (item (1) (iii)) in gross estate	23,235
(iii) Portion of estate tax attributable to net value of items described in section 691 (a) (1)	390
(3) (i) Value in gross estate of items described in section 691 (a) (1) received in taxable year (fee)	1,000
(ii) Value in gross estate of all income items described in section 691 (a) (1) (item (1) (i))	1,500
(iii) Part of estate tax deductible on account of receipt of $1,200 fee (1,000/1,500 of $390)	260

Although $1,200 was later collected as the fee, only the $1,000 actually included in the gross estate is used in the above computations. However, to avoid distortion, section 691 (c) provides that if the value included in the gross estate is greater than the amount finally collected, only the amount collected shall be used in the above computations. Thus, if the amount collected as the fee were only $500, the estate tax deductible on the receipt of such amount would be 500/1,500 of $390, or $130. See paragraph (d) (3) of § 1.421–5 for a similar example involving a restricted stock option.

Example (2). Assume that in example (1) the fee valued at $1,000 had been earned by prior decedent Y and had been inherited by X who died before collecting it. With regard to the son, the fee would be considered income in respect of a prior decedent. Assume further that the fee was valued at $1,000 in Y's estate, that the net value in Y's estate of items described in section 691 (a) (1) was $5,000 and that the estate tax imposed on Y's estate attributable to such net value was $550. In such case, the portion of such estate tax attributable to the fee would be 1,000/5,000 of $550, or $110. When the son collects the $1,200 fee, he will receive for the same taxable year a deduction of $110 with respect to the estate tax imposed on the estate of prior decedent Y as well as the deduction of $260 (as computed in example (1)) with respect to the estate tax imposed on the estate of decedent X.

§ 1.691(c)–2 Estates and trusts.

(a) In the case of an estate or trust, the deduction prescribed in section 691 (c) is determined in the same manner as described in § 1.691 (c)–1, with the following exceptions:

(1) If any amount properly paid, credited, or required to be distributed by an estate or trust to a beneficiary consists of income in respect of a decedent received by the estate or trust during the taxable year—

(i) Such income shall be excluded in determining the income in respect of the decedent with respect to which the estate or trust is entitled to a deduction under section 691 (c), and

(ii) Such income shall be considered income in respect of a decedent to such beneficiary for purposes of allowing the deduction under section 691 (c) to such beneficiary.

(2) For determination of the amount of income in respect of a decedent received by the beneficiary, see sections 652 and 662, and §§ 1.652 (b)–2 and 1.662 (b)–2. However, for this purpose, distributable net income as defined in section 643 (a) and the regulations thereunder shall be computed without taking into account the estate tax deduction provided in section 691 (c) and this section. Distributable net income as modified under the preceding sentence shall be applied for other relevant purposes of subchapter J, chapter 1 of the Code, such as the deduction provided by section 651 or 661, or subpart D, part I of subchapter J, relating to excess distributions by trusts.

(3) The rule stated in subparagraph (1) of this paragraph does not apply to income in respect of a decedent which is properly allocable to corpus by the fiduciary during the taxable year but which is distributed to a beneficiary in a subsequent year. The deduction provided by section 691 (c) in such a case is allowable only to the estate or trust. If any amount properly paid, credited, or required to be distributed by a trust qualifies as a distribution under section 666, the fact that a portion thereof constitutes income in respect of a decedent shall be disregarded for the purposes of determining the deduction of the trust and of the beneficiaries under section 691 (c) since the deduction for estate taxes was taken into consideration in computing the undistributed net income of the trust for the preceding taxable year.

(b) This section shall apply only to amounts properly paid, credited, or required to be distributed in taxable years of an estate or trust beginning after December 31, 1953, and ending after August 16, 1954, except as otherwise provided in paragraph (c) of this section.

(c) In the case of an estate or trust heretofore taxable under the provisions of the Internal Revenue Code of 1939, amounts paid, credited, or to be distributed during its first taxable year subject to the Internal Revenue Code of 1954 which would have been treated as paid, credited, or to be distributed on the last day of the preceding taxable year if the Internal Revenue Code of 1939 were still applicable shall not be subject to the provisions of section 691 (c) (1) (B) or this section. See section 683 and the regulations thereunder.

(d) The provisions of this section may be illustrated by the following example, in which it is assumed that the estate and the beneficiary make their returns on the calendar year basis:

Example. (1) The fiduciary of an estate receives taxable interest of $5,500 and income in respect of a decedent of $4,500 during the taxable year. Neither the will of the decedent nor local law requires the allocation to corpus of income in respect of a decedent. The estate tax attributable to the income in respect of a decedent is $1,500. In his discretion, the fiduciary distributes $2,000 (falling within sections 661 (a) and 662 (a)) to a beneficiary during that year. On these facts the fiduciary and beneficiary are respectively entitled to estate tax deductions of $1,200 and $300, computed as follows:

(2) Distributable net income computed under section 643 (a) without regard to the estate tax deduction under section 691 (c) is $10,000, computed as follows:

Taxable interest	$5,500
Income in respect of a decedent	4,500
Total	10,000

(3) Inasmuch as the distributable net income of $10,000 exceeds the amount of $2,000 distributed to the beneficiary, the deduction allowable to the estate under section 661 (a), and the amount taxable to the beneficiary under section 662 (a) is $2,000.

(4) The character of the amounts distributed to the beneficiary under section 662 (b) is shown in the following table:

	Taxable interest	Income in respect of a decedent	Total
Distributable net income	$5,500	$4,500	$10,000
Amount deemed distributed under section 662 (b)	1,100	900	2,000

(5) Accordingly, the beneficiary will be entitled to an estate tax deduction of $300 (900/4,500 x $1,500) and the estate will be entitled to an estate tax deduction of $1,200 (3,600/4,500 x $1,500).

(6) The taxable income of the estate is $6,200, computed as follows:

Gross income		$10,000
Less:		
Distributions to the beneficiary	$2,000	
Estate tax deduction under section 691 (c)	1,200	
Personal exemption	600	
		3,800
Taxable income		6,200

§ 1.691(d) Statutory provisions; recipients of income in respect of decedents; amounts received by surviving annuitant under joint and survivor annuity contract.

SEC. 691. *Recipients of income in respect of decedents.* * * *

(d) *Amounts received by surviving annuitant under joint and survivor annuity contract*—(1) *Deduction for estate tax.* For purposes of computing the deduction under subsection (c) (1) (A), amounts received by a surviving annuitant—

(A) As an annuity under a joint and survivor annuity contract where the decedent annuitant died after December 31, 1958, and after the annuity starting date (as defined in section 72 (c) (4)), and

(B) During the surviving annuitant's life expectancy period,

shall, to the extent included in gross income under section 72, be considered as amounts included in gross income under subsection (a).

(2) *Net value for estate tax purposes.* In determining the net value for estate tax purposes under subsection (c) (2) (B) for purposes of this subsection, the value for estate tax purposes of the items described in paragraph (1) of this subsection shall be computed—

(A) By determining the excess of the value of the annuity at the date of the death of the deceased annuitant over the total amount excludable from the gross income

of the surviving annuitant under section 72, during the surviving annuitant's life expectancy period, and

(B) By multiplying the figure so obtained by the ratio which the value of the annuity for estate tax purposes bears to the value of the annuity at the date of the death of the deceased.

(3) *Definitions.* For purposes of this subsection—

(A) The term "life expectancy period" means the period beginning with the first day of the first period for which an amount is received by the surviving annuitant under the contract and ending with the close of the taxable year with or in which falls the termination of the life expectancy of the surviving annuitant. For purposes of this subparagraph, the life expectancy of the surviving annuitant shall be determined, as of the date of the death of the deceased annuitant, with reference to actuarial tables prescribed by the Secretary or his delegate.

(B) The surviving annuitant's expected return under the contract shall be computed, as of the death of the deceased annuitant, with reference to actuarial tables prescribed by the Secretary or his delegate.

§ 1.691(d)–1 Amounts received by surviving annuitant under joint and survivor annuity contract.

(a) *In general.* Under section 691(d), annuity payments received by a surviving annuitant under a joint and survivor annuity contract (to the extent indicated in paragraph (b) of this section) are treated as income in respect of a decedent under section 691(a) for the purpose of allowing the deduction for estate tax provided for in section 691(c)(1)(A). This section applies only if the deceased annuitant died after December 31, 1953, and after the annuity starting date as defined in section 72 (c) (4).

(b) *Special value for surviving annuitant's payments.* Section 691 (d) provides a special value for the surviving annuitant's payments to determine the amount of the estate tax deduction provided for in section 691 (c) (1) (A). This special value is determined by multiplying—

(1) The excess of the value of the annuity at the date of death of the deceased annuitant over the total amount excludable from the gross income of the surviving annuitant under section 72 during his life expectancy period (see paragraph (d) (1) (i) of this section)

by

(2) A fraction consisting of the value of the annuity for estate tax purposes over the value of the annuity at the date of death of the deceased annuitant.

This special value is used for the purpose of determining the net value for estate tax purposes (see section 691 (c) (2) (B) and paragraph (a) (1) of §1.691 (c)–1) and for the purpose of determing the portion of estate tax attributable to the survivor's annuity (see paragraph (a) of § 1.691 (c)–1).

(c) *Amount of deduction.* The portion of estate tax attributable to the survivor's annuity (see paragraph (a) of § 1.691(c)–1) is allowable as a deduction to the surviving annuitant over his life expectancy period. If the surviving annuitant continues to receive annuity payments beyond this period, there is no further deduction under section 691 (d). If the surviving annuitant dies before expiration of such period, there is no compensating adjustment for the unused deduction.

(d) *Definitions.* (1) For purposes of section 691 (d) and this section—

(i) The term "life expectancy period" means the period beginning with the first day of the first period for which an amount is received by the surviving annuitant under the contract and ending with the close of the taxable year with or in which falls the termination of the life expectancy of the surviving annuitant.

(ii) The life expectancy of the surviving annuitant shall be determined as of the date of death of the deceased annuitant, with reference to actuarial Table I set forth in § 1.72–9 (but without making any adjustment under paragraph (a) (2) of § 1.72–5).

(iii) The value of the annuity at the date of death of the deceased annuitant shall be the entire value of the survivor's annuity determined by reference to the principles set forth in section 2031 and the regulations thereunder, relating to the valuation of annuities for estate tax purposes.

(iv) The value of the annuity for estate tax purposes shall be that portion of the value determined under subdivision (iii) of this subparagraph which was includible in the deceased annuitant's gross estate.

(2) The determination of the "life expectancy period" of the survivor for purposes of section 691 (d) may be illustrated by the following example:

Example. H and W file their income tax returns on the calendar year basis. H dies on July 15, 1955, on which date W is 70 years of age. On August 1, 1955, W receives a monthly payment under a joint and survivor annuity contract. W's life expectancy determined as of the date of H's death is 15 years as determined from Table I in § 1.72–9; thus her life expectancy ends on July 14, 1970. Under the provisions of section 691 (d), her life expectancy period begins as of July 1, 1955, and ends as of December 31, 1970, thus giving her a life expectancy period of 15½ years.

(e) *Examples.* The application of section 691 (d) and this section may be illustrated by the following examples:

Example (1). (1) H and W, husband and wife, purchased a joint and survivor annuity contract for $203,800 providing for monthly payments of $1,000 starting January 28, 1954, and continuing for their joint lives and for the remaining life of the survivor. H contributed $152,850 and W contributed $50,950 to the cost of the annuity. As of the annuity starting date, January 1, 1954, H's age at his nearest birthday was 70 and W's age at her nearest birthday was 67. H dies on January 1, 1957, and beginning on January 28, 1957, W receives her monthly payments of $1,000. The value of the annuity at the date of H's death is $159,000 (see paragraph (d) (1) (iii) of this section), and the value of the annuity for estate tax purposes (see paragraph (d) (1) (iv) of this section) is $119,250 (152,850/203,800 of $159,000). As of the date of H's death, W's age is 70 and her life expectancy period is 15 years (see paragraph (d) of this section for method of computation). Both H and W reported income by use of the cash receipts and disbursements method and filed income tax returns on the calendar year basis.

(2) The following computations illustrate the application of section 72 in determining the excludable portions of the annuity payments to W during her life expectancy period:

Amount of annuity payments per year (12×$1,000)	$12,000
Life expectancy of H and W as of the annuity starting date (see section 72 (c) (3) (A) and Table II of § 1.72–9 (male, age 70; female, age 67))	19.7
Expected return as of the annuity starting date, January 1, 1954 ($12,000×19.7 as determined under section 72 (c) (3) (A) and paragraph (b) of § 1.72–5)	$236,400
Investment in the contract as of the annuity starting date, Jan. 1, 1954 (see section 72 (c) (1) and paragraph (a) of § 1.72–6)	$203,800
Exclusion ratio (203,800/236,400 as determined under section 72 (b) and § 1.72–4) (percent)	86.2
Exclusion per year under section 72 ($12,000×86.2 percent)	$10,344
Excludable during W's life expectancy period ($10,344×15)	$155,160

(3) For the purpose of computing the deduction for estate tax under section 691 (c), the value for estate tax purposes of the amounts includible in W's gross income and considered income in respect of a decedent by virtue of section 691 (d) (1) is $2,880. This amount is arrived at in accordance with the formula contained in section 691 (d) (2), as follows:

Value of annuity at date of H's death	$159,000
Total amount excludable from W's gross income under section 72 during W's life expectancy period (see subparagraph (2) of this example)	$155,160
Excess	$3,840
Ratio which value of annuity for estate tax purposes bears to value of annuity at date of H's death (119,250/159,000) (percent)	75
Value for estate tax purposes (75 percent of $3,840)	$2,880

This amount ($2,880) is included in the items of income under section 691 (a) (1) for the purpose of determining the estate tax attributable to each item under section 691 (c) (1) (A). The estate tax determined to be attributable to the item of $2,880 is then allowed as a deduction to W over her 15-year life expectancy period (see example (2) of this paragraph).

Example (2). Assume, in addition to the facts contained in example (1) of this paragraph, that H was an attorney and was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued at $1,000, and to accrued bond interest, which was valued at $500. Taking into consideration the annuity payments of example (1), valued at $2,880, a total of $4,380 was included in his gross estate in respect of income described in section 691 (a) (1). There were deducted as claims against his estate $280 for business expenses for which his estate was liable and $100 for taxes accrued on certain property which he owned. In all, $380 was deducted for claims which represent amounts described in section 691 (b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was $404,250 and considering deductions of $15,000, a marital deduction of $119,250 (assuming the annuity to be the only qualifying gift) and an exemption of $60,000, his taxable estate amounted to $210,000. The estate tax on this amount is $53,700 from which is subtracted a $175 credit for State death taxes, leaving an estate tax liability of $53,525. W may deduct, in computing her taxable income during each year of her 15-year life expectancy period,

$14.73 on account of the estate tax attributable to the value for estate tax purposes of that portion of the annuity payments considered income in respect of a decedent, computed as follows:

(1) (i) Value of income described in section 691 (a) (1) included in computing gross estate	$4,380.00
(ii) Deductions in computing gross estate for claims representing deductions described in section 691 (b)	380.00
(iii) Net value of items described in section 691 (a) (1)	4,000.00
(2) (i) Estate tax	53,525.00
(ii) Less: Estate tax computed without including $4,000 (item (1) (iii)) in gross estate and by reducing marital deduction by $2,880 (portion of item (1) (iii) allowed as a marital deduction)	53,189.00
(iii) Portion of estate tax attributable to net value of income items	336.00
(3) (i) Value in gross estate of income attributable to annuity payments	2,880.00
(ii) Value in gross estate of all income items described in section 691 (a) (1) (item (1) (i))	4,380.00
(iii) Part of estate tax attributable to annuity income (2,880/4,380 of $336)	220.98
(iv) Deduction each year on account of estate tax attributable to annuity income ($220.98÷15 (life expectancy period))	14.73

§ 1.691(c) Statutory provisions; recipients of income in respect of decedents; cross reference.

SEC. 691. *Recipients of income in respect of decedents.* * * *

(c) *Cross reference.* For application of this section to income in respect of a deceased partner, see section 753.

§ 1.691(c)–1 Cross reference.

See section 753 and the regulations thereunder for application of section 691 to income in respect of a deceased partner.

§ 1.692 Statutory provisions; income taxes on members of Armed Forces on death.

SEC. 692. *Income taxes on members of Armed Forces on death.* In the case of any individual who dies during an induction period (as defined in section 112 (c) (5)) while in active service as a member of the Armed Forces of the United States, if such death occurred while serving in a combat zone (as determined under section 112) or as a result of wounds, disease, or injury incurred while so serving—

(1) Any tax imposed by this subtitle shall not apply with respect to the taxable year in which falls the date of his death, or with respect to any prior taxable year ending on or after the first day he so served in a combat zone after June 24, 1950; and

(2) Any tax under this subtitle and under the corresponding provisions of prior revenue laws for taxable years preceding those specified in paragraph (1) which is unpaid at the date of his death (including interest, additions to the tax, and additional amounts) shall not be assessed, and if assessed the assessment shall be abated, and if collected shall be credited or refunded as an overpayment.

§ 1.692–1 Abatement of income taxes of certain members of the Armed Forces of the United States upon death.

(a) If an individual dies during an induction period (as defined in section 112(c)(5)) while in active service as a member of the Armed Forces of the United States, and such death occurs while serving in a combat zone (as determined under section 112) or at any place as a result of wounds, disease, or injury incurred while so serving, then—

(1) The tax liability of such individual, under subtitle A of the Internal Revenue Code of 1954 or under chapter 1 of the Internal Revenue Code of 1939, for the taxable year ending on the date of his death, and for any prior taxable year ending on or after the first day he so served in a combat zone after June 24, 1950, is cancelled and if the tax (including interest, additions to the tax, and additional amounts) is assessed, the assessment shall be abated, and if the amount of such tax is collected (regardless of the date of collection) the amount so collected shall be credited or refunded as an overpayment; and

(2) That amount of tax of such individual for taxable years preceding those specified in subparagraph (1) of this paragraph, under subtitle A of the Internal Revenue Code of 1954, chapter 1 of the Internal Revenue Code of 1939 or corresponding provisions of prior revenue laws, which remains unpaid as of the date of death shall not be assessed, and if any such unpaid tax (including interest, additions to the tax, and additional amounts) has been assessed, such assessment shall be abated, and if the amount of any such unpaid tax is collected subsequent to the date of death, the amount so collected shall be credited or refunded as an overpayment.

As to what constitutes an induction period, active service as a member of the Armed Forces, service in a combat zone, and wounds, disease, or injury incurred while serving in a combat zone, see section 112 and the regulations thereunder. As to who are members of the Armed Forces, see section 7701 (a) (15) and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration).

(b) If such an individual and his spouse have for any such year filed a joint return, the tax abated, credited, or refunded pursuant to the provisions of section 692 for such year shall be an amount equal to that portion of the joint tax liability which is the same percentage of such joint tax liability as a tax computed upon the separate income of such individual is of the sum of the taxes computed upon the separate income of such individual and his spouse, but with respect to taxable years ending before June 24, 1950, and with respect to taxable years ending before the first day such individual served in a combat zone, as determined under section 112, the amount so abated, credited, or refunded shall not exceed the amount unpaid at the date of death. For such purpose, the separate tax of each spouse—

(1) For taxable years beginning after December 31, 1953, and ending after August 16, 1954, shall be the tax computed under subtitle A of the Internal Revenue Code of 1954 before the application of sections 31, 32, 6401 (b), and 6402, but after the application of section 33, as if such spouse were required to make a separate income tax return; and

(2) For taxable years beginning before January 1, 1954, and for taxable years beginning after December 31, 1953, and ending before August 17, 1954, shall be the tax computed under chapter 1 of the Internal Revenue Code of 1939 before the application of sections 32, 35, and 322 (a), but after the application of section 31, as if such spouse were required to make a separate income tax return.

(c) If such an individual and his spouse filed a joint declaration of estimated tax for the taxable year ending with the date of his death, the estimated tax paid pursuant to such declaration may be treated as the estimated tax of either such individual or his spouse, or may be divided between them, in such manner as his legal representative and such spouse may agree. Should they agree to treat such estimated tax, or any portion thereof, as the estimated tax of such individual, the estimated tax so paid shall be credited or refunded as an overpayment for the taxable year ending with the date of his death.

(d) For the purpose of determining the tax which is unpaid at the date of death, amounts deducted and withheld under chapter 24, subtitle C of the Internal Revenue Code of 1954, or under subchapter D, chapter 9 of the Internal Revenue Code of 1939 (relating to income tax withheld at source on wages), constitute payment of tax imposed under subtitle A of the Internal Revenue Code of 1954 or under chapter 1 of the Internal Revenue Code of 1939, as the case may be.

(e) This section shall have no application whatsoever with respect to the liability of an individual as a transferee of property of a taxpayer where such liability relates to the tax imposed upon the taxpayer by subtitle A of the Internal Revenue Code of 1954 or by chapter 1 of the Internal Revenue Code of 1939.

PARTNERS AND PARTNERSHIPS

DETERMINATION OF TAX LIABILITY

§ 1.701 Statutory provisions; partners, not partnership, subject to tax.

SEC. 701. *Partners, not partnership, subject to tax.* A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

§ 1.701–1 Partners, not partnership, subject to tax.

Partners are liable for income tax only in their separate capacities. Partnerships as such are not subject to the income tax imposed by subtitle A but are required to make returns of income under the provisions of section 6031 and the regulations thereunder. For definition of the terms "partner" and "partnership", see sections 761 and 7701(a)(2), and the regulations thereunder. For provisions relating to the election of

certain partnerships to be taxed as domestic corporations, see section 1361 and the regulations thereunder.

§ 1.702 Statutory provisions; income and and credits of partner.

SEC. 702. *Income and credits of partner*—(a) *General rule.* In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

(1) Gains and losses from sales or exchanges of capital assets held for not more than 6 months,

(2) Gains and losses from sales or exchanges of capital assets held for more than 6 months,

(3) Gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),

(4) Charitable contributions (as defined in section 170 (c)),

(5) Dividends with respect to which there is provided a credit under section 34, an exclusion under section 116, or a deduction under part VIII of subchapter B,

(6) Taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(7) Partially tax-exempt interest on obligations of the United States or on obligations of instrumentalities of the United States as described in section 35 or section 242 (but, if the partnership elects to amortize the premiums on bonds as provided in section 171, the amount received on such obligations shall be reduced by the reduction provided under section 171 (a) (3)),

(8) Other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary or his delegate, and

(9) Taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

(b) *Character of items constituting distributive share.* The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

(c) *Gross income of a partner.* In any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership.

§ 1.702–1 Income and credits of partner.

(a) *General rule.* Each partner is required to take into account separately in his return his distributive share, whether or not distributed, of each class or item of partnership income, gain, loss, deduction, or credit described in subparagraphs (1) through (9) of this paragraph. (For the taxable year in which a partner includes his distributive share of partnership taxable income, see section 706 (a) and § 1.706–1 (a). Such distributive share shall be determined as provided in section 704 and § 1.704–1.) Accordingly, in determining his income tax:

(1) Each partner shall take into account, as part of his gains and losses from sales or exchanges of capital assets held for not more than six months, his distributive share of the combined net amount of such gains and losses of the partnership.

(2) Each partner shall take into account, as part of his gains and losses from sales or exchanges of capital assets held for more than six months, his distributive share of the combined net amount of such gains and losses of the partnership.

(3) Each partner shall take into account, as part of his gains and losses from sales or exchanges of property described in section 1231 (relating to property used in the trade or business and involuntary conversions), his distributive share of the combined net amount of such gains and losses of the partnership . The partnership shall not combine such items with items set forth in subparagraph (1) or (2) of this paragraph.

(4) Each partner shall take into account, as part of the charitable contributions paid by him, his distributive share of each class of charitable contributions paid by the partnership within the partnership's taxable year. Section 170 determines the extent to which such amount may be allowed as a deduction to the partner. For the definition of the term "charitable contribution", see section 170 (c).

(5) Each partner shall take into account, as part of the dividends received by him from domestic corporations, his distributive share of dividends received by the partnership, with respect to which the partner is entitled to a credit under section 34, an exclusion under section 116, or a deduction under part VIII, subchapter B, chapter 1 of the Code.

(6) Each partner shall take into account, as part of his taxes described in section 901 which have been paid or accrued to foreign countries or to possessions of the United States, his distributive share of such taxes which have been paid or accrued by the partnership, according to its method of treating such taxes. A partner may elect to treat his total amount of such taxes, including his distributive share of such taxes of the partnership, as a deduction under section 164 or as a credit under section 901, subject to the provisions of sections 901 through 905.

(7) Each partner shall take into account, as part of the partially tax-exempt interest received by him on obligations of the United States or on obligations of instrumentalities of the United States, as described in section 35 or section 242, his distributive share of such partially tax-exempt interest received by the partnership. However, if the partnership elects to amortize premiums on bonds as provided in section 171, the amount received on such obligations by the partnership shall be reduced by the amortizable bond premium applicable to such obligations as provided in section 171 (a) (3).

(8) (i) Each partner shall take into account separately, as part of any class of income, gain, loss, deduction, or credit, his distributive share of the following items: recoveries of bad debts, prior taxes, and delinquency amounts (section 111); gains and losses from wagering transactions (section 165 (d)); soil and water conservation expenditures (section 175); nonbusiness expenses as described in section 212; medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); amounts representing taxes and interest paid to cooperative housing corporations (section 216); intangible drilling and developments costs (section 263 (c)); exploration expenditures (section 615); income, gain, or loss to the partnership under section 751 (b); and any items of income, gain, loss, deduction, or credit subject to a special allocation under the partnership agreement which differs from the allocation of partnership taxable income or loss generally.

(ii) Each partner must also take into account separately his distributive share of any partnreship item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately. Thus, if any partner would qualify for the retirement income credit under section 37 if the partnership pensions and annuities, interest, rents, dividends, and earned income were separately stated, such items must be separately stated for all partners. Under section 911 (a), if any partner is a bona fide resident of a foreign country who may exclude from his gross income the part of his distributive share which qualifies as earned income as defined in section 911 (b), the earned income of the partnership for all partners must be separately stated. Similarly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 270 (relating to "hobby losses") and the recomputation of tax thereunder for any partner.

(iii) Each partner shall aggregate the amount of his separate deductions or exclusions and his distributive share of partnership deductions or exclusions separately stated in determining the amount allowable to him of any deduction or exclusion under subtitle A of the Code as to which a limitation is imposed. For example, partner A has individual exploration expenditures of $75,000. He is also a member of the AB partnership which has exploration expenditures of $120,000. A's distributive share of this item is $60,000. However, the total amount that A can deduct as exploration expenditures under section 615 (a) is limited to $100,000. Therefore, the excess of $35,000 ($135,000 minus $100,000) is not deductible by A.

(9) Each partner shall also take into account separately his distributive share of the taxable income or loss of the partnership, exclusive of items requiring separate computations under subparagraphs (1) through (8) of this paragraph. For limitation on allowance of a partner's distributive share of partnership losses, see section 704 (d) and paragraph (d) of § 1.704–1.

(b) *Character of items constituting distributive share.* The character in the hands of a partner of any item of income, gain, loss, deduction, or credit described in section 702 (a) (1) through (8) shall be determined as if such item were realized directly from the source

from which realized by the partnership or incurred in the same manner as incurred by the partnership. For example, a partner's distributive share of gain from the sale of depreciable property used in the trade or business of the partnership shall be considered as gain from the sale of such depreciable property in the hands of the partner. Similarly, a partner's distributive share of partnership "hobby losses" (section 270) or his distributive share of partnership charitable contributions to churches, educational organizations, or hospitals (section 170 (b) (1) (A)) retains such character in the hands of the partner.

(c) *Gross income of a partner.* (1) Where it is necessary to determine the amount or character of the gross income of a partner, his gross income shall include the partner's distributive share of the gross income of the partnership, that is, the amount of gross income of the partnership from which was derived the partner's distributive share of partnership taxable income or loss (including items described in section 702 (a) (1) through (8)). For example, a partner is required to include his distributive share of partnership gross income:

(i) In computing his gross income for the purpose of determining the necessity of filing a return (section 6012 (a));

(ii) In determining the application of the provision permitting the spreading of income for services rendered over a 36-month period (section 1301);

(iii) In computing the amount of gross income received from sources within possessions of the United States (section 931); and

(iv) In determining a partner's "gross income from farming" (sections 175 and 6073).

(2) In determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501 (e) (relating to omisssion of more than 25 percent of gross income), a partner's gross income includes his distributive share of partnership gross income (as described in section 6501 (e) (1) (A) (i)). In this respect, the amount of partnership gross income from which was derived the partner's distributive share of any item of partnership income, gain, loss, deduction, or credit (as included or disclosed in the partner's return) is considered as an amount of gross income stated in the partner's return for the purposes of section 6501 (e). For example, A, who is entitled to one-fourth of the profits of the ABCD partnership, which has $10,000 gross income and $2,000 taxable income, reports only $300 as his distributive share of partnership profits. A should have shown $500 as his distributive share of profits, which amount was derived from $2,500 of partnership gross income. However, since A included only $300 on his return without explaining in the return the difference of $200, he is regarded as having stated in his return only $1,500 ($300/$500 of $2,500) as gross income from the partnership.

(d) *Partners in community property States.* If separate returns are made by a husband and wife domiciled in a community property State, and only one spouse is a member of the partnership, the part of his or her distributive share of any item or items listed in paragraph (a) (1) through (9) of this section which is community property, or which is derived from community property, should be reported by the husband and wife in equal proportions.

§ 1.702–2 Net operating loss deduction of partner.

For the purpose of determining a net operating loss deduction under section 172, a partner shall take into account his distributive share of items of income, gain, loss, deduction, or credit of the partnership. The character of any such item shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. See section 702(b) and paragraph (b) of § 1.702–1. To the extent necessary to determine the allowance under section 172(d)(4) of the nonbusiness deductions of a partner (arising from both partnership and nonpartnership sources), the partner shall separately take into account his distributive share of the deductions of the partnership which are not attributable to a trade or business and combine such amount with his nonbusiness deductions from nonpartnership sources. Such partner shall also separately take into account his distributive share of the gross income of the partnership not derived from a trade or business and combine such amount with his nonbusiness income from nonpartnership sources. See section 172 and the regulations thereunder.

§ 1.703 Statutory provisions; partnership computations.

SEC. 703. *Partnership computations*—(a) *Income and deductions.* The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that—

(1) The items described in section 702 (a) shall be separately stated, and

(2) The following deductions shall not be allowed to the partnership:

(A) The standard deduction provided in section 141,

(B) The deductions for personal exemptions provided in section 151,

(C) The deduction for taxes provided in section 164 (a) with respect to taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(D) The deduction for charitable contributions provided in section 170,

(E) The net operating loss deduction provided in section 172, and

(F) The additional itemized deductions for individuals provided in part VII of subchapter B (sec. 211 and following).

(b) *Elections of the partnership.* Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that the election under section 901, relating to taxes of foreign countries and possessions of the United States, shall be made by each partner separately.

§ 1.703–1 Partnership computations.

(a) *Income and deductions.* (1) The taxable income of a partnership shall be computed in the same manner as the taxable income of an individual, except as otherwise provided in this section. A partnership is required to state separately in its return the items described in section 702 (a) (1) through (7) and, in addition, to attach to its return a statement setting forth separately those items described in section 702 (a) (8) which the partner is required to take into account separately in determining his income tax. See paragraph (a) (8) of § 1.702–1. The partnership is further required to compute and to state separately in its return:

(i) As taxable income under section 702 (a) (9), the total of all other items of gross income (not separately stated) over the total of all other allowable deductions (not separately stated), or

(ii) As loss under section 702 (a) (9), the total of all other allowable deductions (not separately stated) over the total of all other items of gross income (not separately stated).

The taxable income or loss so computed shall be accounted for by the partners in accordance with their partnership agreement.

(2) The partnership is not allowed the following deductions:

(i) The standard deduction provided in section 141.

(ii) The deduction for personal exemptions provided in section 151.

(iii) The deduction provided in section 164 (a) for taxes, described in section 901, paid or accrued to foreign countries or possessions of the United States. Each partner's distributive share of such taxes shall be accounted for separately by him as provided in section 702 (a) (6).

(iv) The deduction for charitable contributions provided in section 170. Each partner is considered as having paid within his taxable year his distributive share of any contribution or gift, payment of which was actually made by the partnership within its taxable year ending within or with the partner's taxable year. This item shall be accounted for separately by the partners as provided in section 702 (a) (4). See also paragraph (b) of § 1.702–1.

(v) The net operating loss deduction provided in section 172. See § 1.702–2

(vi) The additional itemized deductions for individuals provided in part VII, subchapter B, chapter 1 of the Code, as follows: expenses for production of income (section 212); medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); and amounts representing taxes and interest paid to cooperative housing corporation (section 216). However, see paragraph (a) (8) of § 1.702–1.

(vii) The deduction for capital gains provided by section 1202 and the deduction for capital loss carryover provided by section 1212.

(b) *Elections of the partnership*—(1) *General rule.* Any elections (other than the election with respect to foreign taxes) affecting the computation of income derived from a partnership shall be made by the partnership. For example, elections of methods of accounting, of computing depreciation, of treating soil and water conservation expenditures, of

treating exploration expenditures, and the option to deduct as expenses intangible drilling and development costs, shall be made by the partnership and not by the partners separately. All partnership elections are applicable to all partners equally, but any election made by a partnership shall not apply to any partner's nonpartnership interests.

(2) *Exception.* Each partner shall add his distributive share of taxes described in section 901 paid or accrued by the partnership to foreign countries or possessions of the United States (according to its method of treating such taxes) to any such taxes paid or accrued by him (according to his method of treating such taxes), and may elect to use the total amount either as a credit against tax or as a deduction from income.

§ 1.704 Statutory provisions; partner's distributive share.

SEC. 704. *Partner's distributive share*—(a) *Effect of partnership agreement.* A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

(b) *Distributive share determined by income or loss ratio.* A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702 (a) (9), for the taxable year, if—

(1) The partnership agreement does not provide as to the partner's distributive share of such item, or

(2) The principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

(c) *Contributed property*—(1) *General rule.* In determining a partner's distributive share of items described in section 702 (a), depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, except to the extent otherwise provided in paragraph (2) or (3), be allocated among the partners in the same manner as if such property had been purchased by the partnership.

(2) *Effect of partnership agreement.* If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the Secretary or his delegate, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

(3) *Undivided interests.* If the partnership agreement does not provide otherwise, depreciation, depletion, or gain or loss with respect to undivided interests in property contributed to a partnership shall be determined as though such undivided interests had not been contributed to the partnership. This paragraph shall apply only if all the partners had undivided interests in such property prior to contribution and their interests in the capital and profits of the partnership correspond with such undivided interests.

(d) *Limitation on allowance of losses.* A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

(e) *Family partnerships*—(1) *Recognition of interest created by purchase or gift.* A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

(2) *Distributive share of donee includible in gross income.* In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

(3) *Purchase of interest by member of family.* For purposes of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

§ 1.704–1 Partner's distributive share.

(a) *Effect of partnership agreement.* A partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit of the partnership shall be determined by the partnership agreement, unless otherwise provided by section 704 and paragraphs (b) through (e) of this section. For definition of partnership agreement see section 761 (c).

(b) *Distributive share determined by income or loss ratio.* (1) If the partnership agreement makes no specific provision for the manner of sharing one or more items or classes of items, a partner's distributive share of such items shall be determined in accordance with the provisions of the partnership agreement for the division of the general profits or losses (that is, the taxable income or loss of the partnership as described in section 702 (a) (9)). In applying this rule, the manner in which the net profit or loss (computed after excluding any item subject to a recognized special allocation) is actually credited on the partnership books to the accounts of the partners will generally determine each partner's share of taxable income or loss as described in section 702 (a) (9).

(2) If the principal purpose of any provision in the partnership agreement determining a partner's distributive share of a particular item is to avoid or evade the Federal income tax, the provision shall be disregarded and the partners' distributive shares of that item shall be determined in accordance with the ratio in which the partners divide the general profits or losses of the partnership (as described in section 702 (a) (9)). In determining whether the principal purpose of any provision in the partnership agreement for a special allocation is the avoidance or evasion of Federal income tax, the provision must be considered in relation to all the surrounding facts and circumstances. Among the relevant circumstances are the following: Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has "substantial economic effect", that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences; whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation. The application of the provisions of this subparagraph may be illustrated by the following examples:

Example (1). The provisions of a partnership agreement for a year in which the partnership incurs losses on the sale of depreciable property used in the trade or business are amended to allocate such losses to one partner who has no such gains individually. An equivalent amount of partnership loss or deduction of a different character is allocated to other partners who individually have gains from the sale of depreciable property used in the trade or business. Since the purpose and effect of this allocation is solely to reduce the taxes of certain partners without actually affecting their shares of partnership income, such allocation will not be recognized. Under section 704 (b) (2), those items will be allocated to all the partners in accordance with the provisions of the partnership agreement for sharing partnership income or loss generally.

Example (2). The provisions of a partnership agreement allocate to a partner who is a resident of a foreign country a percentage of the profit derived from operations conducted by him within such country, which percentage is greater than his distributive share of partnership income generally. Such allocation has substantial economic effect and will be recognized in the absence of other circumstances showing that the principal purpose was tax avoidance or evasion.

Example (3). Rather than impair the credit standing of the AB partnership by a distribution, the partners agree to invest surplus partnership funds in an equal dollar amount of municipal bonds and corporate stock. The partners further agree that A is to receive all the interest income and gain or loss from tax-exempt bonds and B is to receive all the dividend income and gain or loss from corporate stock. Such allocation has substantial economic effect and will be recognized in the absence of other circumstances showing that the principal purpose was tax avoidance or evasion. On the other hand, under an agreement with respect to partnership CD, it is provided that C's distributive share of income shall be the first $10,000 of tax-exempt income, and D's distributive share of income shall be the first $10,000 of dividend income, the balances to be divided equally. Since the principal purpose of this provision is to allocate tax-exempt interest to C, who is in a higher income tax bracket than D, it will be disregarded. Each partner's distributive share of such interest and dividends will then be allocated in accordance with the provisions of the partnership agreement for sharing partnership income or loss generally.

Example (4). KL is a brokerage partnership with assets consisting of securities with a basis of $20,000 and a value of $50,000. M makes a $25,000 cash contribution to the partnership in order to become an equal partner. Subsequently, when the value of the securities has appreciated to $74,000, they are sold. Of the $54,000 taxable gain on the sale of the securities, $24,000 (appreciation in value occurring after M became a partner) is allocated in equal shares to K, L, and M, in accordance with the ratio for sharing profits and losses generally. The $30,000 balance is allocated to K and L in the profit and loss ratio existing before M became a partner. This latter allocation attributes to K and L the appreciation in value of the securities occurring before M became a partner, even though the cash proceeds are a partnership asset in which all three partners share equally. This allocation has substantial economic effect and will be recognized in the absence of other circumstances showing that the principal purpose of the allocation was tax avoidance or evasion.

Example (5). G and H enter into a partnership agreement to develop and market an electronic device. H, an electronics engineer, contributes $2,500 cash and agrees to devote his full-time services to the partnership. G contributes $100,000 cash and agrees to obtain a loan for the partnership of any additional capital needed. The partnership agreement provides that the full amount of any research and experimental expenditures and any interest on partnership loans are to be charged to G. It also provides that G's distributive share is to be 90 percent of partnership income or loss computed without reduction by such research and experimental expenditures and such interest, until all loans have been repaid and G has received through his 90 percent share of income an amount equal to the full amount of such research and experimental expenditures, of such interest, and his share of any partnership operating losses. During this time H's distributive share will be 10 percent. Thereafter, G and H will share profits and losses equally. Since all of the research and experimental expenditures and interest specially allocated to G are in fact borne by G, the allocation will be recognized in the absence of other circumstances showing that its principal purpose was tax avoidance or evasion.

(c) *Contributed property*—(1) *In general.* Where property has actually been contributed by a partner to a partnership (so as to become partnership property as among the partners and not merely property subject to the claims of partnership creditors), section 704 (c) and this paragraph provide rules for determining a partner's distributive share of depreciation, depletion, or gain or loss with respect to such contributed property. These rules do not apply to property, only the use of which is permitted the partnership by the partner who owns it. Section 704 (c) and this paragraph provide certain alternatives in determining the partners' distributive shares of such items in order to account for precontribution appreciation or diminution in value of the property contributed. When the partnership agreement is silent as to the treatment of such items with respect to contributed property (and if such property is not an undivided interest as described in section 704 (c) (3)), depreciation, depletion, or gain or loss with respect to such property shall be treated in the same manner as though such items arose with respect to property purchased by the partnership. The application of this provision may be illustrated by the following examples:

Example (1). A and B form an equal partnership. A contributes $1,000 cash and B contributes inventory with an adjusted basis to him of $800 and a fair market value of $1,000. Under section 723, the basis of the inventory to the partnership is also $800. During the year, the inventory is sold for $1,100. There is no provision in the partnership agreement for treatment of items with respect to contributed property. Under section 704 (c) (1), the $300 profit on the sale of the inventory is treated as if it were gain on property that had been purchased by the partnership and subsequently sold. Therefore, each partner's distributive share of such profit on the inventory is $150.

Example (2). C and D form an equal partnership. C contributes machinery worth $10,000 with an adjusted basis to him of $4,000. D contributes $10,000 cash. Under the provisions of section 722, the basis of C's partnership interest is $4,000 and the basis of D's interest is $10,000. There is no provision in the partnership agreement relating to contributed property. If the contributed property depreciates at an annual rate of 10 percent, the partnership will have an annual depreciation deduction of $400, which will result in a reduction of $200 in each partner's distributive share of partnership income. Thus, at the end of the first year, the adjusted basis of the contributed property will be $3,600. If the partnership has no other taxable income or loss for that year, each partner will have a deduction of $200, representing his distributive share of partnership loss for the year. C's adjusted basis for his interest will be $3,800 ($4,000, the original basis of his interest, reduced by $200); D's adjusted basis will be $9,800 ($10,000, reduced by $200).

Example (3). Assume that the property in example (2) of this subparagraph is sold at the beginning of the second year of partnership operation for $9,000. The partnership gain will be $5,400 ($9,000, the amount realized, less the adjusted basis of $3,600). Each partner's share of the $5,400 gain will be $2,700. If the partnership has no other taxable income or loss for that year, each partner will have a gain from the partnership of $2,700, representing his distributive share of gain from the sale of property used in the partnership business. C's adjusted basis for his interest will then be $6,500 (the basis of $3,800, increased by the gain of $2,700). D's adjusted basis will be $12,500 (the basis of $9,800, increased by the gain of $2,700). If the partnership is then terminated, and its assets consisting of $19,000 in cash are distributed to the partners pro rata in liquidation of their entire interests, C will have a capital gain of $3,000 ($9,500, the amount received, less $6,500, the adjusted basis of his interest). D will have a capital loss of $3,000 (D's adjusted basis, $12,500, reduced by the amount received, $9,500).

(2) *Effect of partnership agreement.* (i) If the partners so provide in the partnership agreement, depreciation, depletion, or gain or loss with respect to contributed property may be allocated among the partners in a manner which takes into account all or any portion of the difference between the adjusted basis and the fair market value of contributed property at the time of contribution. The allocation may apply to all contributed property or to specific items. The appreciation or diminution in value represented by the difference between the adjusted basis and the fair market value of contributed property at the time of contribution may thus be attributed to the contributing partner upon a subsequent sale or exchange of the property by the partnership. Such appreciation or diminution also may be used in allocating the allowable depreciation or depletion with respect to such property among the contributing partner and the noncontributing partners. In any case, however, the total depreciation, depletion, or gain or loss allocated to the partners is limited to a "ceiling" which cannot exceed the amount of gain or loss realized by the partnership or the depreciation or depletion allowable to it. The application of this subdivision may be illustrated by the following examples:

Example (1). Assume that partners C and D, in examples (2) and (3) of subparagraph (1) of this paragraph, agree under section 704 (c) (2) to attribute to C, the contributor of the machinery, the potential gain of $6,000 represented by the difference between its adjusted basis of $4,000 and its fair market value of $10,000. With his contribution of $10,000 cash, D has, in effect, purchased an undivided one-half interest in the property for $5,000. Since the property depreciates at an annual rate of 10 percent, D would have been entitled to a depreciation deduction of $500 per year. However, since under the "ceiling" approach the partnership is allowed only $400 per year (10 percent of $4,000), no more than $400 may be allocated between the partners, i. e., the partnership cannot allocate $500 of depreciation to D and thereby treat C as if C had received an additional $100 of income. Therefore, the partners allocate the $400 deduction for depreciation entirely to D and none to C, the contributor. At the end of the first year, the adjusted basis of the contributed property will be $3,600. Since the $400 deduction is allocated entirely to D, if the partnership has no other taxable income or loss, C will have no income or loss, and D will have a deduction of $400. C's basis for his interest will remain $4,000. D's adjusted basis for his interest will be $9,600 ($10,000, the original basis of his interest, reduced by the deduction of $400).

Example (2). Assume that the partners in example (1) of this subdivision also agree under section 704 (c) (2) that, upon a sale of the contributed property, the portion of the proceeds attributable to the excess of the fair market value of the property at date of contribution (less accumulated depreciation on such value) over its basis at date of contribution (less accumulated depreciation on such basis) shall result in gain to the contributing partner only. If the property is sold at the beginning of the second year of partnership operation for $9,000, the partnership gain of $5,400 ($9,000, the amount realized, less the adjusted basis of $3,600) must be allocated to the partners under the terms of the agreement. The fair market value of the property as depreciated is $9,000 ($10,000, the value on contribution, less $1,000, the accumulated depreciation on such value). Under section 704 (c) (2) and the terms of the partnership agreement, the $5,400 difference between $9,000, the fair market value as depreciated, and $3,600, the adjusted basis of the property, represents the portion of the gain to be allocated to C. None of this gain is allocated to D. (If the property were sold for more than $9,000, the portion of the gain in excess of $5,400 would be allocated equally between the partners in accordance with their agreement for sharing gains. If the property were sold for less than $9,000, the entire gain would be allocated to C and nothing to D.) If the partnership and partners engaged in no other transactions that year, C will report a gain of $5,400, and D, no income or loss. C's adjusted basis for his interest will then be $9,400 ($4,000, his original basis, increased by the gain of $5,400). D's adjusted basis will be $9,600 ($10,000, his

original basis, less $400 depreciation deduction in the first partnership year). If the partnership is then terminated, and its assets consisting of $19,000 in cash are distributed to the partners pro rata in liquidation of their interests, C will have a capital gain of $100 ($9,500, the amount received, less $9,400, the adjusted basis of his interest). D will have a capital loss of $100 (the excess of D's adjusted basis, $9,600, over the amount received, $9,500).

(ii) For the effect of an agreement under section 704 (c) (2) on undivided interests in property contributed to the partnership where the partners' interests in the capital and profits of the partnership do not correspond with such undivided interests, see subparagraph (3) (ii) of this paragraph.

(3) *Undivided interests.* (i) Section 704 (c) (3) provides a special rule for the allocation of depreciation, depletion, or gain or loss with respect to undivided interests in property contributed by the partners to a partnership where the partnership agreement does not provide otherwise. This provision applies only to property contributed to a partnership by all of its partners and only where the relative undivided interests of the partners in the property prior to the contribution are in the same ratio as their interests in the capital and in the profits of the partnership (except for depreciation, depletion, or gain or loss with respect to the contributed undivided interest) after the contribution. Where these conditions are met, depreciation, depletion, or gain or loss with respect to the undivided interests in contributed property shall be determined in the same manner as though such undivided interests continued to be held by the partners outside the partnership. The rule stated in section 704 (c) (3) applies only to the case where persons actually contribute undivided interests to a partnership. The provisions of this subdivision may be illustrated by the following examples:

Example (1). A and B are tenants in common owning undivided one-half interests in improved real estate consisting of land on which a factory is situated. They each contribute their respective undivided interests in the real estate to a partnership in which the profits are to be divided equally and, because the partners have equal shares in the capital, the assets will be divided equally on dissolution. A's basis for his undivided one-half interest is $4,000, of which $1,000 is allocable to the land and $3,000 to the factory. B's basis for his undivided one-half interest is $10,000, of which $3,000 is allocable to the land and $7,000 to the factory. The partnership agreement contains no provisions as to the allocation of depreciation or gain or loss on disposition of the property by the partnership. The factory depreciates at a rate of 5 percent a year. The annual partnership allowance for depreciation of $500 (5 percent of $10,000) will be allocated between the partners by allowing A a deduction of $150 (5 percent of $3,000, his basis for his undivided interest in the factory), and by allowing B a deduction of $350 (5 percent of $7,000, his basis for his undivided interest in the factory). At the end of the first year of partnership operation, A's adjusted basis for his undivided interest in the factory is $2,850 ($3,000 less $150), and B's adjusted basis is $6,650 ($7,000 less $350).

Example (2). If, in example (1) of this subdivision, the partnership at the end of the first year's operation sells the factory and land for $12,000, each partner's share of the gain or loss would be determined as follows: Since the undivided interests in the factory and the land are to be treated as though held by the partners outside the partnership, A's share of the proceeds of the sale is $6,000. His adjusted basis in the contributed property is $3,850 ($1,000 for the land and $2,850 for the factory). Therefore, his gain from the sale is $2,150. Since B's share of the proceeds is also $6,000, and his adjusted basis in the contributed property is $9,650 ($3,000 for the land and $6,650 for the factory), his loss is $3,650.

Example (3). Assume the same facts as in examples (1) and (2) of this subdivision, except that A and B do not enter into a partnership agreement. Assume further that they are found to be a partnership for income tax purposes because of their joint business activity, but that the factory and the land are not actually contributed by them to the partnership. Although A and B have permitted the partnership to use such properties, they continue to own the factory and the land in their individual capacities (as tenants in common), and the same tax consequences result as in examples (1) and (2) of this subdivision.

(ii) The allocation illustrated in subdivision (i) of this subparagraph will not be affected by the contribution, either at the time of the original contribution or subsequent thereto, of additional property not held as undivided interests if the partners' respective interests in the capital and in the profits of the partnership (except for depreciation, depletion, or gain or loss with respect to the contributed undivided interests) remain the same as their undivided interests in the property previously contributed to the partnership. If the partners' interests in the capital and profits of the partnership are changed from their undivided interests in the property previously contributed to the partnership, the method of allocation of depreciation, depletion, or gain or loss with respect to such property no longer applies. Such a change of the partner's interests in capital and profits may result from a modification of the agreement, or from a change in a partner's respective interest in capital either as a result of a further contribution or as a result of a distribution. (However, drawings made throughout the year against profits, and loans will be disregarded.) Where such a change takes place, the partners may agree under section 704 (c) (2) that depreciation, depletion, or gain or loss with respect to the property formerly held as undivided interests shall continue to be allocated in the same manner as prior to the change. These provisions may be illustrated by the following examples:

Example (1). C and D are tenants in common, each owning an undivided one-half interest in certain unimproved land. Each contributes his respective undivided interest in the land to a partnership in which each has an equal interest in capital and profits. C's basis for his one-half interest is $4,000; D's basis is $10,000. The fair market value of the land is $20,000. Subsequently, C contributes $5,000 cash to his share of partnership capital. As a result of C's additional contribution, he now has a 60-percent interest in partnership capital and D, a 40-percent interest, although profits and losses still are to be shared equally. Since the interests of the partners in the capital and profits of the partnership no longer correspond to their undivided interests in the land, the method of allocation prescribed by section 704 (c) (3) no longer applies. Therefore, if the land is sold for $12,000, the partnership will have a loss of $2,000 ($14,000 partnership basis minus $12,000). Since the partnership agreement contains no special allocation for gain or loss with respect to contributed property, the $2,000 loss is allocated as if such property had been purchased by the partnership, i. e., $1,000 to each partner.

Example (2). Assume in example (1) of this subdivision that the partners agree that, because of C's additional contribution of $5,000 cash, he is to have a 60-percent interest in partnership capital. Profits and losses still are to be shared equally, except that gain or loss with respect to the land is, under section 704 (c) (2), to continue to be allocated in the same manner as it had been allocated under section 704 (c) (3) prior to the additional contribution. The land is sold for $12,000. C's share of the proceeds is $6,000. His basis for the land is $4,000. Therefore, he has a $2,000 gain. D's loss is $4,000 ($10,000 basis less $6,000 proceeds).

(d) *Limitation on allowance of losses.* (1) A partner's distributive share of partnership loss will be allowed only to the extent of the adjusted basis (before reduction by current year's losses) of such partner's interest in the partnership at the end of the partnership taxable year in which such loss occurred. A partner's share of loss in excess of his adjusted basis at the end of the partnership taxable year will not be allowed for that year. However, any loss so disallowed shall be allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero (before reduction by such loss for such year).

(2) In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be increased under section 705 (a) (1) and decreased under section 705 (a) (2), except for losses of the taxable year and losses previously disallowed. If the partner's distributive share of the aggregate of items of loss specified in section 702 (a) (1), (2), (3), (8), and (9) exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704 (d) must be allocated to his distributive share of each such loss. This allocation shall be determined by taking the proportion that each loss bears to the total of all such losses. For purposes of the preceding sentence, the total losses for the taxable year shall be the sum of his distributive share of losses for the current year and his losses disallowed and carried forward from prior years.

(3) For the treatment of certain liabilities of the partner or partnership, see section 752 and § 1.752–1.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example (1). At the end of the partnership taxable year 1955, partnership AB has a loss of $20,000. Partner A's distributive share of this loss is $10,000. At the end such year, A's adjusted basis for his interest in the partnership (not taking into account

his distributive share of the loss) is $6,000. Under section 704 (d), A's distributive share of partnership loss is allowed to him (in his taxable year within or with which the partnership taxable year ends) only to the extent of his adjusted basis of $6,000. The $6,000 loss allowed for 1955 decreases the adjusted basis of A's interest to zero. Assume that, at the end of partnership taxable year 1956, A's share of partnership income has increased the adjusted basis of A's interest in the partnership to $3,000 (not taking into account the $4,000 loss disallowed in 1955). Of the $4,000 loss disallowed for the partnership taxable year 1955, $3,000 is allowed A for the partnership taxable year 1956, thus again decreasing the adjusted basis of his interest to zero. If, at the end of partnership taxable year 1957, A has an adjusted basis of his interest of at least $1,000 (not taking into account the disallowed loss of $1,000), he will be allowed the $1,000 loss previously disallowed.

Example (2). At the end of partnership taxable year 1955, partnership CD has a loss of $20,000. Partner C's distributive share of this loss is $10,000. The adjusted basis of his interest in the partnership (not taking into account his distributive share of such loss) is $6,000. Therefore, $4,000 of the loss is disallowed. At the end of partnership taxable year 1956, the partnership has no taxable income or loss, but owes $8,000 to a bank for money borrowed. Since C's share of this liability is $4,000, the basis of his partnership interest is increased from zero to $4,000. (See sections 752 and 722, and §§ 1.752–1 and 1.722–1.) C is allowed the $4,000 loss, disallowed for the preceding year under section 704 (d), for his taxable year within or with which partnership taxable year 1956 ends.

Example (3). At the end of partnership taxable year 1955, partner C has the following distributive share of partnership items described in section 702 (a): long-term capital loss, $4,000; short-term capital loss, $2,000; income as described in section 702 (a) (9), $4,000. Partner C's adjusted basis for his partnership interest at the end of 1955, before adjustment for any of the above items, is $1,000. As adjusted under section 705 (a) (1) (A), C's basis is increased from $1,000 to $5,000 at the end of the year. C's total distributive share of partnership loss is $6,000. Since without regard to losses, C has a basis of only $5,000, C is allowed only $5,000/$6,000 of each loss, that is, $3,333 of his long-term capital loss, and $1,667 of his short-term capital loss. C must carry forward to succeeding taxable years $667 as a long-term capital loss and $333 as a short-term capital loss.

(e) *Family partnerships*—(1) *In general*—(i) *Introduction.* The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. The provisions of subchapter K, chapter 1 of the Code, are to be read in the light of their relationship to section 61, which requires, inter alia, that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.

(ii) *Recognition of donee as partner.* With respect to partnerships in which capital is a material income-producing factor, section 704 (e) (1) provides that a person shall be recognized as a partner for income tax purposes if he owns a capital interest in such a partnership whether or not such interest is derived by purchase or gift from any other person. If a capital interest in a partnership in which capital is a material income-producing factor is created by gift, section 704 (e) (2) provides that the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such distributive share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. For rules of allocation in such cases, see subparagraph (3) of this paragraph.

(iii) *Requirement of complete transfer to donee.* A donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704 (e) (1) unless such interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes, and the donee or purchaser is the real owner of such interest. To be recognized, a transfer must vest dominion and contol of the partnership interest in the transferee. The existence of such dominion and control in the donee is to be determined from all the facts and circumstances. A transfer is not recognized if the transferor retains such incidents of ownership that the transferee has not acquired full and complete ownership of the partnership interest. Transactions between members of a family will be closely scrutinized, and the circumstances, not only at the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides or lack of bona fides of the purported gift or sale. A partnership may be recognized for income tax purposes as to some partners but not as to others.

(iv) *Capital as a material income-producing factor.* For purposes of section 704 (e) (1), the determination as to whether capital is a material income-producing factor must be made by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.

(v) *Capital interest in a partnership.* For purposes of section 704 (e), a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

(2) *Basic tests as to ownership*—(i) *In general.* Whether an alleged partner who is a donee of a capital interest in a partnership is the real owner of such capital interest, and whether the donee has dominion and control over such interest, must be ascertained from all the facts and circumstances of the particular case. Isolated facts are not determinative; the reality of the donee's ownership is to be determined in the light of the transaction as a whole. The execution of legally sufficient and irrevocable deeds or other instruments of gift under State law is a factor to be taken into account but is not determinative of ownership by the donee for the purposes of section 704 (e). The reality of the transfer and of the donee's ownership of the property attributed to him are to be ascertained from the conduct of the parties with respect to the alleged gift and not by any mechanical or formal test. Some of the more important factors to be considered in determining whether the donee has acquired ownership of the capital interest in a partnership are indicated in subdivisions (ii) to (x), inclusive, of this subparagraph.

(ii) *Retained controls.* The donor may have retained such controls of the interest which he has purported to transfer to the donee that the donor should be treated as remaining the substantial owner of the interest. Controls of particular significance include, for example, the following:

(*a*) Retention of control of the distribution of amounts of income or restrictions on the distributions of amounts of income (other than amounts retained in the partnership annually with the consent of the partners, including the donee partner, for the reasonable needs of the business). If there is a partnership agreement providing for a managing partner or partners, then amounts of income may be retained in the partnership without the acquiescence of all the partners if such amounts are retained for the reasonable needs of the business.

(*b*) Limitation of the right of the donee to liquidate or sell his interest in the partnership at his discretion without financial detriment.

(*c*) Retention of control of assets essential to the business (for example, through retention of assets leased to the alleged partnership).

(*d*) Retention of management powers inconsistent with normal relationships among partners. Retention by the donor of control of business management or of voting control, such as is common in ordinary business relationships, is not by itself to be considered as inconsistent with normal relationships among partners, provided the donee is free to liquidate his interest at his discretion without financial detriment. The donee shall not be considered free to liquidate his interest unless, considering all the facts, it is evident that the donee is independent of the donor and has such maturity and understanding of his rights as to be capable of deciding to exercise, and capable of exercising, his right to withdraw his capital interest from the partnership.

The existence of some of the indicated controls, though amounting to less than

substantial ownership retained by the donor, may be considered along with other facts and circumstances as tending to show the lack of reality of the partnership interest of the donee.

(iii) *Indirect controls.* Controls inconsistent with ownership by the donee may be exercised indirectly as well as directly, for example, through a separate business organization, estate, trust, individual, or other partnership. Where such indirect controls exist, the reality of the donee's interest will be determined as if such controls were exercisable directly.

(iv) *Participation in management.* Substantial participation by the donee in the control and management of the business (including participation in the major policy decisions affecting the business) is strong evidence of a donee partner's exercise of dominion and control over his interest. Such participation presupposes sufficient maturity and experience on the part of the donee to deal with the business problems of the partnership.

(v) *Income distributions.* The actual distribution to a donee partner of the entire amount or a major portion of his distributive share of the business income for the sole benefit and use of the donee is substantial evidence of the reality of the donee's interest, provided the donor has not retained controls inconsistent with real ownership by the donee. Amounts distributed are not considered to be used for the donee's sole benefit if, for example, they are deposited, loaned, or invested in such manner that the donor controls or can control the use or enjoyment of such funds.

(vi) *Conduct of partnership business.* In determining the reality of the donee's ownership of a capital interest in a partnership, consideration shall be given to whether the donee is actually treated as a partner in the operation of the business. Whether or not the donee has been held out publicly as a partner in the conduct of the business, in relations with customers, or with creditors or other sources of financing, is of primary significance. Other factors of significance in this connection include:

(*a*) Compliance with local partnership, fictitious names, and business registration statutes.

(*b*) Control of business bank accounts.

(*c*) Recognition of the donee's rights in distributions of partnership property and profits.

(*d*) Recognition of the donee's interest in insurance policies, leases, and other business contracts and in litigation affecting business.

(*e*) The existence of written agreements, records, or memoranda, contemporaneous with the taxable year or years concerned, establishing the nature of the partnership agreement and the rights and liabilities of the respective partners.

(*f*) Filing of partnership tax returns as required by law.

However, despite formal compliance with the above factors, other circumstances may indicate that the donor has retained substantial ownership of the interest purportedly transferred to the donee.

(vii) *Trustees as partners.* A trustee may be recognized as a partner for income tax purposes under the principles relating to family partnerships generally as applied to the particular facts of the trust-partnership arrangement. A trustee who is unrelated to and independent of the grantor, and who participates as a partner and receives distribution of the income distributable to the trust, will ordinarily be recognized as the legal owner of the partnership interest which he holds in trust unless the grantor has retained controls inconsistent with such ownership. However, if the grantor is the trustee, or if the trustee is amenable to the will of the grantor, the provisions of the trust instrument (particularly as to whether the trustee is subject to the responsibilities of a fiduciary), the provisions of the partnership agreement, and the conduct of the parties must all be taken into account in determining whether the trustee in a fiduciary capacity has become the real owner of the partnership interest. Where the grantor (or person amenable to his will) is the trustee, the trust may be recognized as a partner only if the grantor (or such other person) in his participation in the affairs of the partnership actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interests to the interests of the grantor. Furthermore, if the grantor (or person amenable to his will) is the trustee, the following factors will be given particular consideration:

(*a*) Whether the trust is recognized as a partner in business dealings with customers and creditors, and

(*b*) Whether, if any amount of the partnership income is not properly retained for the reasonable needs of the business, the trust's share of such amount is distributed to the trust annually and paid to the beneficiaries or reinvested with regard solely to the interests of the beneficiaries.

(viii) *Interests (not held in trust) of minor children.* Except where a minor child is shown to be competent to manage his own property and participate in the partnership activities in accordance with his interest in the property, a minor child generally will not be recognized as a member of a partnership unless control of the property is exercised by another person as fiduciary for the sole benefit of the child, and unless there is such judicial supervision of the conduct of the fiduciary as is required by law. The use of the child's property or income for support for which a parent is legally responsible will be considered a use for the parent's benefit. "Judicial supervision of the conduct of the fiduciary" includes filing of such accountings and reports as are required by law of the fiduciary who participates in the affairs of the partnership on behalf of the minor. A minor child will be considered as competent to manage his own property if he actually has sufficient maturity and experience to be treated by disinterested persons as competent to enter business dealings and otherwise to conduct his affairs on a basis of equality with adult persons, notwithstanding legal disabilities of the minor under State law.

(ix) *Donees as limited partners.* The recognition of a donee's interest in a limited partnership will depend, as in the case of other donated interests, on whether the transfer of property is real and on whether the donee has acquired dominion and control over the interest purportedly transferred to him. To be recognized for Fedeal income tax purposes, a limited partnership must be organized and conducted in accordance with the requirements of the applicable State limited-partnership law. The absence of services and participation in management by a donee in a limited partnership is immaterial if the limited partnership meets all the other requirements prescribed in this paragraph. If the limited partner's right to transfer or liquidate his interest is subject to substantial restrictions (for example, where the interest of the limited partner is not assignable in a real sense or where such interest may be required to be left in the business for a long term of years), or if the general partner retains any other control which substantially limits any of the rights which would ordinarily be exercisable by unrelated limited partners in normal business relationships, such restrictions on the right to transfer or liquidate, or retention of other control, will be considered strong evidence as to the lack of reality of ownership by the donee.

(x) *Motive.* If the reality of the transfer of interest is satisfactorily established, the motives for the transaction are generally immaterial. However, the presence or absence of a tax-avoidance motive is one of many factors to be considered in determining the reality of the ownership of a capital interest acquired by gift.

(3) *Allocation of family partnership income*—(i) *In general.* (*a*) Where a capital interest in a partnership in which capital is a material income-producing factor is created by gift, the donee's distributive share shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the distributive share attributable to the donor's capital. For the purpose of section 704, a capital interest in a partnership purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual, for the purpose of the preceding sentence, shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons.

(*b*) To the extent that the partnership agreement does not allocate the partnership income in accordance with (*a*) of this subdivision, the distributive shares of the partnership income of the

donor and donee shall be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of such income (other than a reasonable allowance for the services, if any, rendered by the donee) to the partnership capital of the donor and donee. The portion of income, if any, thus attributable to partnership capital for the taxable year shall be allocated between the donor and donee in accordance with their respective interests in partnership capital.

(c) In determining a reasonable allowance for services rendered by the partners, consideration shall be given to all the facts and circumstances of the business, including the fact that some of the partners may have greater managerial responsibility than others. There shall also be considered the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the partnership.

(d) The distributive share of partnership income, as determined under (b) of this subdivision, of a partner who rendered services to the partnership before entering the Armed Forces of the United States shall not be diminished because of absence due to military service. Such distributive share shall be adjusted to reflect increases or decreases in the capital interest of the absent partner. However, the partners may by agreement allocate a smaller share to the absent partner due to his absence.

(ii) *Special rules.* (a) The provisions of subdivision (i) of this subparagraph, relating to allocation of family partnership income, are applicable where the interest in the partnership is created by gift, indirectly or directly. Where the partnership interest is created indirectly, the term "donor" may include persons other than the nominal transferor. This rule may be illustrated by the following examples:

Example (1). A father gives property to his son who shortly thereafter conveys the property to a partnership consisting of the father and the son. The partnership interest of the son may be considered created by gift and the father may be considered the donor of the son's partnership interest.

Example (2). A father, the owner of a business conducted as a sole proprietorship, transfers the business to a partnership consisting of his wife and himself. The wife subsequently conveys her interest to their son. In such case, the father, as well as the mother, may be considered the donor of the son's partnership interest.

Example (3). A father makes a gift to his son of stock in the family corporation. The corporation is subsequently liquidated. The son later contributes the property received in the liquidation of the corporation to a partnership consisting of his father and himself. In such case, for purposes of section 704, the son's partnership interest may be considered created by gift and the father may be considered the donor of his son's partnership interest.

(b) The allocation rules set forth in section 704 (e) and subdivision (i) of this subparagraph apply in any case in which the transfer or creation of the partnership interest has any of the substantial characteristics of a gift. Thus, allocation may be required where transfer of a partnership interest is made between members of a family (including collaterals) under a purported purchase agreement, if the characteristics of a gift are ascertained from the terms of the purchase agreement, the terms of any loan or credit arrangements made to finance the purchase, or from other relevant data.

(c) In the case of a limited partnership, for the purpose of the allocation provisions of subdivision (i) of this subparagraph, consideration shall be given to the fact that a general partner, unlike a limited partner, risks his credit in the partnership business.

(4) *Purchased interest*—(i) *In general.* If a purported purchase of a capital interest in a partnership does not meet the requirements of subdivision (ii) of this subparagraph, the ownership by the transferee of such capital interest will be recognized only if it qualifies under the requirements applicable to a transfer of a partnership interest by gifts. In a case not qualifying under subdivision (ii) of this subparagraph, if payment of any part of the purchase price is made out of partnership earnings, the transaction may be regarded in the same light as a purported gift subject to deferred enjoyment of income. Such a transaction may be lacking in reality either as a gift or as a bona fide purchase.

(ii) *Tests as to reality of purchased interests.* A purchase of a capital interest in a partnership, either directly or by means of a loan or credit extended by a member of the family, will be recognized as bona fide if:

(a) It can be shown that the purchase has the usual characteristics of an arm's-length transaction, considering all relevant factors, including the terms of the purchase agreement (as to price, due date of payment, rate of interest, and security, if any) and the terms of any loan or credit arrangement collateral to the purchase agreement; the credit standing of the purchaser (apart from relationship to the seller) and the capacity of the purchaser to incur a legally binding obligation; or

(b) It can be shown, in the absence of characteristics of an arm's-length transaction, that the purchase was genuinely intended to promote the success of the business by securing participation of the purchaser in the business or by adding his credit to that of the other participants.

However, if the alleged purchase price or loan has not been paid or the obligation otherwise discharged, the factors indicated in (a) and (b) of this subdivision shall be taken into account only as an aid in determining whether a bona fide purchase or loan obligation existed.

§ 1.705 Statutory provisions; determination of basis of partner's interest.

SEC. 705. *Determination of basis of partner's interest*—(a) *General rule.* The adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests)—

(1) Increased by the sum of his distributive share for the taxable year and prior taxable years of—

(A) Taxable income of the partnership as determined under section 703 (a),

(B) Income of the partnership exempt from tax under this title, and

(C) The excess of the deductions for depletion over the basis of the property subject to depletion; and

(2) Decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable year and prior taxable years of—

(A) Losses of the partnership, and

(B) Expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

(b) *Alternative rule.* The Secretary or his delegate shall prescribe by regulations the circumstances under which the adjusted basis of a partner's interest in a partnership may be determined by reference to his proportionate share of the adjusted basis of partnership property upon a termination of the partnership.

§ 1.705–1 Determination of basis of partner's interest.

(a) *General rule.* (1) Section 705 and this section provide rules for determining the adjusted basis of a partner's interest in a partnership. A partner is required to determine the adjusted basis of his interest in a partnership only when necessary for the determination of his tax liability or that of any other person. The determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a partnership taxable year. Thus, for example, such year-end determination is necessary in ascertaining the extent to which a partner's distributive share of partnership losses may be allowed. See section 704 (d). However, where there has been a sale or exchange of all or a part of a partnership interest or a liquidation of a partner's entire interest in a partnership, the adjusted basis of the partner's interest should be determined as of the date of sale or exchange or liquidation. The adjusted basis of a partner's interest in a partnership is determined without regard to any amount shown in the partnership books as the partner's "capital", equity", or similar account. For example, A contributes property with an adjusted basis to him of $400 (and a value of $1,000) to a partnership. B contributes $1,000 cash. While under their agreement each may have a "capital account" in the partnership of $1,000, the adjusted basis of A's interest is only $400 and B's interest $1,000.

(2) The original basis of a partner's interest in a partnership shall be determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests). Such basis shall be increased under section 722 by any further contributions to the partnership and by the sum of the partner's distributive share for the taxable year and prior taxable years of—

(i) Taxable income of the partnership as determined under section 703 (a),

(ii) Tax-exempt receipts of the partnership, and

(iii) The excess of the deductions for depletion over the basis of the depletable property.

(3) The basis shall be decreased (but not below zero) by distributions from the partnership as provided in section 733 and by the sum of the partner's distributive share for the taxable year and prior taxable years of—

(i) Partnership losses (including capital losses), and

(ii) Partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures.

(4) For the effect of liabilities in determining the amount of contributions made by a partner to a partnership or the amount of distributions made by a partnership to a partner, see section 752 and § 1.752–1, relating to the treatment of certain liabilities. In determining the basis of a partnership interest on the effective date of subchapter K, chapter 1 of the Code, or any of the sections thereof, the partner's share of partnership liabilities on that date shall be included.

(b) *Alternative rule.* In certain cases, the adjusted basis of a partner's interest in a partnership may be determined by reference to the partner's share of the adjusted basis of partnership property which would be distributable upon termination of the partnership. The alternative rule may be used to determine the adjusted basis of a partner's interest where circumstances are such that the partner cannot practicably apply the general rule set forth in section 705 (a) and paragraph (a) of this section, or where, from a consideration of all the facts, it is, in the opinion of the Commissioner, reasonable to conclude that the result produced will not vary substantially from the result obtainable under the general rule. Where the alternative rule is used, adjustments may be necessary in determining the adjusted basis of a partner's interest in a partnership. Adjustments would be required, for example, in order to reflect in a partner's share of the adjusted basis of partnership property any significant discrepancies arising as a result of contributed property, transfers of partnership interests, or distributions of property to the partners. The operation of the alternative rules may be illustrated by the following examples:

Example (1). The ABC partnership, in which A, B, and C are equal partners, owns various properties with a total adjusted basis of $1,500 and has earned and retained an additional $1,500. The total adjusted basis of partnership property is thus $3,000. Each partner's share in the adjusted basis of partnership property is one-third of this amount, or $1,000. Under the alternative rule, this amount represents each partner's adjusted basis for his partnership interest.

Example (2). Assume that partner A in example (1) of this paragraph sells his partnership interest to D for $1,250 at a time when the partnership property with an adjusted basis of $1,500 had appreciated in value to $3,000, and when the partnership also had $750 in cash. The total adjusted basis of all partnership property is $2,250 and the value of such property is $3,750. D's basis for his partnership interest is his cost, $1,250. However, his one-third share of the adjusted basis of partnership property is only $750. Therefore, for the purposes of the alternative rule, D has an adjustment of $500 in determining the basis of his interest. This amount represents the difference between the cost of his partnership interest and his share of partnership basis at the time of his purchase. If the partnership subsequently earns and retains an additional $1,500, its property will have an adjusted basis of $3,750. D's adjusted basis for his interest under the alternative rule is $1,750, determined by adding $500, his basis adjustment to $1,250 (his one-third share of the $3,750 adjusted basis of partnership property). If the partnership distributes $250 to each partner in a current distribution, D's adjusted basis for his interest will be $1,500 ($1,000, his one-third share of the remaining basis of partnership property, $3,000, plus his basis adjustment of $500).

Example (3). Assume that BCD partnership in example (2) of this paragraph continues to operate. In 1960, D proposes to sell his partnership interest and wishes to evaluate the tax consequences of such sale. It is necessary, therefore, to determine the adjusted basis of his interest in the partnership. Assume further that D cannot determine the adjusted basis of his interest under the general rule. The balance sheet of the BCD partnership is as follows:

Assets	Adjusted basis per books	Market value
Cash	$3,000	$3,000
Receivables	4,000	4,000
Depreciable property	5,000	5,000
Land held for investment	18,000	30,000
Total	30,000	42,000

Liabilities and capital	Per books
Liabilities	$6,000
Capital accounts:	
B	4,500
C	4,500
D	15,000
Total	30,000

The $15,000 representing the amount of D's capital account does not reflect the $500 basis adjustment arising from D's purchase of his interest. See example (2) of this paragraph. The adjusted basis of D's partnership interest determined under the alternative rule is as follows:

D's share of the adjusted basis of partnership property (reduced by the amount of liabilities) at time of proposed sale	$15,000
D's share of partnership liabilities (under the partnership agreement liabilities are shared equally)	2,000
D's basis adjustment from example (2)	500
Adjusted basis of D's interest at the time of proposed sale, as determined under alternative rule	17,500

§ 1.706 Statutory provisions; taxable years of partner and partnership.

SEC. 706. *Taxable years of partner and partnership*—(a) *Year in which partnership income is includible.* In computing the taxable income of a partner for a taxable year, the inclusions required by section 702 and section 707 (c) with respect to a partnership shall be based on the income, gain, loss, deduction, or credit of the partnership for any taxable year of the partnership ending within or with the taxable year of the partner.

(b) *Adoption of taxable year*—(1) *Partnership's taxable year.* The taxable year of a partnership shall be determined as though the partnership were a taxpayer. A partnership may not change to, or adopt, a taxable year other than that of all its principal partners unless it establishes, to the satisfaction of the Secretary or his delegate, a business purpose therefor.

(2) *Partner's taxable year.* A partner may not change to a taxable year other than that of a partnership in which he is a principal partner unless he establishes, to the satisfaction of the Secretary or his delegate, a business purpose therefor.

(3) *Principal partner.* For the purpose of this subsection, a principal partner is a partner having an interest of 5 percent or more in partnership profits or capital.

(c) *Closing of partnership year*—(1) *General rule.* Except in the case of a termination of a partnership and except as provided in paragraph (2) of this subsection, the taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership.

(2) *Partner who retires or sells interest in partnership*—(A) *Disposition of entire interest.* The taxable year of a partnership shall close—

(i) With respect to a partner who sells or exchanges his entire interest in a partnership, and

(ii) With respect to a partner whose interest is liquidated, except that the taxable year of a partnership with respect to a partner who dies shall not close prior to the end of the partnership's taxable year.

Such partner's distributive share of items described in section 702 (a) for such year shall be determined, under regulations prescribed by the Secretary or his delegate, for the period ending with such sale, exchange, or liquidation.

(B) *Disposition of less than entire interest.* The taxable year of a partnership shall not close (other than at the end of a partnership's taxable year as determined under subsection (b) (1)) with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to a partner whose interest is reduced, but such partner's distributive share of items described in section 702 (a) shall be determined by taking into account his varying interests in the partnership during the taxable year.

§ 1.706–1 Taxable years of partner and partnership.

(a) *Year in which partnership income is includible.* (1) In computing his taxable income for a taxable year, a partner is required to include his distributive share of partnership items set forth in section 702 for any partnership year ending within or with his taxable year. A partner shall also include in his taxable income for a taxable year "guaranteed payments" under section 707(c) which are made to him in a partnership taxable year ending within or with his taxable year. The provisions of this subparagraph may be illustrated by the following example:

Example. Partner A reports his income for a calendar year, while the partnership of which he is a member reports its income for a fiscal year ending May 31. During the partnership taxable year ending May 31, 1956, A received guaranteed payments of

$1,200 for services and for the use of capital. Of this amount, $700 was received by A between June 1 and December 31, 1955, and the remaining $500 was received by him between January 1 and May 31, 1956. This entire $1,200 received by A is includible in his taxable income for the calendar year 1956 (together with his distributive share of partnership items set forth in section 702 for the partnership taxable year ending May 31, 1956).

(2) If a partner receives distributions under section 731 or sells or exchanges all or part of his partnership interest, any gain or loss arising therefrom does not constitute partnership income and is includible in the partner's gross income for his taxable year in which the payment is made. See sections 451 and 461.

(b) *Adoption or change in taxable year*—(1) *Partnership taxable year.* (i) The taxable year of a partnership shall be determined as though the partnership were a taxpayer.

(ii) A newly formed partnership may adopt a taxable year which is the same as the taxable year of all its principal partners (or the same as the taxable year to which all of its principal partners are concurrently changing) without securing prior approval from the Commissioner, or it may adopt a calendar year without securing prior approval from the Commissioner if all its principal partners are not on the same taxable year. In any other case, a newly formed partnership must secure prior approval from the Commissioner for the adoption of a taxable year.

(iii) An existing partnership may not change its taxable year without securing prior approval from the Commissioner, unless all its principal partners have the same taxable year to which the partnership changes, or unless all its principal partners concurrently change to such taxable year.

(2) *Partner's taxable year.* A partner may not change his taxable year without securing prior approval from the Commissioner. See section 442 and the regulations thereunder.

(3) *Principal partner.* For the purpose of this paragraph, a principal partner is a partner having an interest of 5 percent or more in partnership profits or capital.

(4) *Application for approval*—(i) *Change.* Application for a change in a taxable year shall be filed on Form 1128 with the Commissioner on or before the last day of the month following the close of the short period for which a return is required to effect the change of taxable year.

(ii) *Adoption.* Where a newly formed partnership is required to secure prior approval from the Commissioner for the adoption of a taxable year, the partnership shall file an application on Form 1128 with the Commissioner on or before the last day of the month following the close of the taxable year to be adopted. The partnership shall modify Form 1128 to the extent necessary to indicate that it is an application for adoption of a taxable year.

(iii) *Business purpose.* Where prior approval is required under this paragraph, the applicant must establish a business purpose to the satisfaction of the Commissioner. For example, partnership AB, which is on a calendar year, is engaged in a business which has a natural business year (the annual accounting period encompassing all related income and expenses) ending on September 30th. The intention of the partnership to make its tax year coincide with such natural business year constitutes a sufficient business purpose.

(5) *Returns*—(i) *Partner.* A partner who changes his taxable year shall make his return for a short period in accordance with section 443, and shall attach to the return a copy of the letter from the Commissioner granting approval for the change of taxable year.

(ii) *Partnership.* (*a*) A partnership which changes its taxable year shall make its return for a short period in accordance with section 443, but shall not annualize the partnership taxable income. The partnership shall attach to the return either a copy of the letter from the Commissioner granting approval of the change of taxable year, or a statement indicating that the partnership is changing its taxable year to the same taxable year as that of all its principal partners or to the same taxable year as that to which all its principal partners are concurrently changing.

(*b*) Any newly formed partnership shall file with its first return either:

(*1*) A copy of the letter from the Commissioner approving the adoption of a partnership taxable year which is not the same as the taxable year of all its principal partners; or

(*2*) A statement indicating that the taxable year it has adopted is the same as the taxable year of all its principal partners, or that all its principal partners are concurrently changing to the taxable year it has adopted; or

(*3*) A statement that all its principal partners are not on the same taxable year and that it is adopting a calendar year without prior approval.

(6) *Effective date.* Section 706 (b) applies to any partnership which adopts or changes to a taxable year beginning on or after April 2, 1954, and to any partner who changes to a taxable year beginning on or after that date. For the purpose of applying this provision, section 708 (relating to the continuation of a partnership) applies to any such taxable year. See section 771 (b) (1) and paragraph (b) (1) of § 1.771–1. If a partnership has changed to or adopted, or if a partner has changed to, a taxable year beginning on or after April 2, 1954, without obtaining prior approval of the Commissioner, and if, under the provisions of this paragraph, prior approval is required for the change or adoption, such annual accounting period will not be accepted as a taxable year until approval thereof is secured. Under these circumstances, an application to change to or adopt the desired taxable year will be considered timely if filed before August 23, 1956.

(c) *Closing of partnership year*—(1) *General rule.* Section 706 (c) and this paragraph provide rules governing the closing of partnership years. The closing of a partnership taxable year or a termination of a partnership for Federal income tax purposes is not necessarily governed by the "dissolution", "liquidation", etc., of a partnership under State or local law. The taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's entire interest in the partnership (as defined in section 761 (d)), or the sale or exchange of a partner's interest in the partnership, except in the case of a termination of a partnership and except as provided in subparagraph (2) of this paragraph. In the case of termination, the partnership taxable year closes for all partners as of the date of termination. See section 708 (b) and paragraph (b) of § 1.708–1.

(2) *Partner who retires or sells interest in partnership*—(i) *Disposition of entire interest.* A partnership taxable year shall close with respect to a partner who sells or exchanges his entire interest in a partnership, and with respect to a partner whose entire interest is liquidated. However, a partnership taxable year with respect to a partner who dies shall not close prior to the end of such partnership taxable year, or the time when such partner's interest (held by his estate or other successor) is liquidated or sold or exchanged, whichever is earlier. See subparagraph (3) of this paragraph.

(ii) *Inclusions in taxable income.* In the case of a sale, exchange, or liquidation of a partner's entire interest in a partnership, the partner shall include in his taxable income for his taxable year within or with which his membership in the partnership ends, his distributive share of items described in section 702 (a), and any guaranteed payments under section 707 (c), for his partnership taxable year ending with the date of such sale, exchange, or liquidation. In order to avoid an interim closing of the partnership books, such partner's distributive share of items described in section 702 (a) may, by agreement among the partners, be estimated by taking his pro rata part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year. The proration may be based on the portion of the taxable year that has elapsed prior to the sale, exchange, or liquidation, or may be determined under any other method that is reasonable. Any partner who is the transferee of such partner's interest shall include in his taxable income, as his distributive share of items described in section 702 (a) with respect to the acquired interest, the pro rata part (determined by the method used by the transferor partner) of the amount of such items he would have included had he been a partner from the beginning of the taxable year of the partnership. The application of this subdivision may be illustrated by the following example:

Example. Assume that a partner selling his partnership interest on June 30, 1955, has an adjusted basis for his interest of $5,000 on that date; that his pro rata share of partnership income up to June 30 is $15,000; and that he sells his interest for $20,000. Under the provisions of section 706 (c) (2).

the partnership year with respect to him closes at the time of the sale. The $15,000 is includible in his income as his distributive share and, under section 705, it increases the basis of his partnership interest to $20,000, which is also the selling price of his interest. Therefore, no gain is realized on the sale of his partnership interest. The purchaser of this partnership interest shall include in his income as his distributive share his pro rata part of partnership income for the remainder of the partnership taxable year.

(3) *Partner who dies.* (i) When a partner dies, the partnership taxable year shall not close with respect to such partner prior to the end of the partnership taxable year. The partnership taxable year shall continue both for the remaining partners and the decedent partner. Where the death of a partner results in the termination of the partnership, the partnership taxable year shall close for all partners on the date of such termination under section 708 (b) (1) (A). See also paragraph (b) (1) (i) (*b*) of § 1.708–1 for the continuation of a 2-member partnership under certain circumstances after the death of a partner. However, if the decedent partner's estate or other successor sells or exchanges its entire interest in the partnership, or if its entire interest is liquidated, the partnership taxable year with respect to the estate or other successor in interest shall close on the date of such sale or exchange, or the date of completion of the liquidation.

(ii) The last return of a decedent partner shall include only his share of partnership taxable income for any partnership taxable year or years ending within or with the last taxable year for such decedent partner (i. e., the year ending with the date of his death). The distributive share of partnership taxable income for a partnership taxable year ending after the decedent's last taxable year is includible in the return of his estate or other successor in interest. If the estate or other successor in interest of a partner continues to share in the profits or losses of the partnership business, the distributive share thereof is includible in the taxable year of the estate or other successor in interest within or with which the taxable year of the partnership ends. See also paragraph (a) (1) (ii) of § 1.736–1. Where the estate or other successor in interest receives distributions, any gain or loss on such distributions is includible in its gross income for its taxable year in which the distribution is made.

(iii) If a partner (or a retiring partner), in accordance with the terms of the partnership agreement, designates a person to succeed to his interest in the partnership after his death, such designated person shall be regarded as a successor in interest of the deceased for purposes of this chapter. Thus, where a partner designates his widow as the successor in interest, her distributive share of income for the taxable year of the partnership ending within or with her taxable year may be included in a joint return in accordance with the provisions of sections 2 and 6013 (a) (2) and (3).

(iv) If, under the terms of an agreement existing at the date of death of a partner, a sale or exchange of the decedent partner's interest in the partnership occurs upon that date, then the taxable year of the partnership with respect to such decedent partner shall close upon the date of death. See section 706 (c) (2) (A) (i). The sale or exchange of a partnership interest does not, for the purpose of this rule, include any transfer of a partnership interest which occurs at death as a result of inheritance or any testamentary disposition.

(v) To the extent that any part of a distributive share of partnership income of the estate or other successor in interest of a deceased partner is attributable to the decedent for the period ending with the date of his death, such part of the distributive share is income in respect of the decedent under section 691. See section 691 and the regulations thereunder.

(vi) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). B has a taxable year ending December 31 and is a member of partnership ABC, the taxable year of which ends on June 30. B dies on October 31, 1955. His estate (which as a new taxpayer may, under section 441 and the regulations thereunder, adopt any taxable year) adopts a taxable year ending October 31. The return of the decedent for the period January 1 to October 31, 1955, will include only his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955. The distributive share of taxable income of the partnership for its taxable year ending June 30, 1956, arising from the interest of the decedent, will be includible in the return of the estate for its taxable year ending October 31, 1956. That part of the distributive share attributable to the decedent for the period ending with the date of his death (July 1 through October 31, 1955) is income in respect of a decedent under section 691.

Example (2). Assume the same facts as in example (1) of this subdivision, except that, prior to B's death, B and D had agreed that, upon B's death, D would purchase B's interest for $10,000. When B dies on October 31, 1955, the partnership taxable year beginning July 1, 1955, closes with respect to him. Therefore, the return for B's last taxable year (January 1 to October 31, 1955) will include his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955, plus his distributive share of partnership taxable income for the period July 1 to October 31, 1955. See subdivision (iv) of this subparagraph.

Example (3). H is a member of a partnership having a taxable year ending December 31. Both H and his wife W are on a calendar year and file joint returns. H dies on March 31, 1955. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 1955. Such distribution by the estate is not a sale or exchange of H's partnership interest. No part of the taxable income of the partnership for the taxable year ending December 31, 1955, which is allocable to H, will be included in H's taxable income for his last taxable year (January 1 through March 31, 1955) or in the taxable income of H's estate for the taxable year April 1 through November 30, 1955. The distributive share of partnership taxable income for the full calendar year that is allocable to H will be includible in the taxable income of W for her taxable year ending December 31, 1955, and she may file a joint return under sections 2 and 6013 (a) (3). That part of the distributive share attributable to the decedent for the period ending with the date of his death (January 1 through March 31, 1955) is income in respect of a decedent under section 691.

Example (4). M is a member of partnership JKM which operates on a calendar year. M and his wife S file joint returns for calendar years. In accordance with the partnership agreement, M designated S to succeed to his interest in the partnership upon his death. M, who had withdrawn $10,000 from the partnership before his death, dies on October 20, 1955. S's distributive share of income for the taxable year 1955 is $15,000 ($10,000 of which represents the amount withdrawn by M). S shall include $15,000 in her income, even though M received $10,000 of this amount before his death. S may file a joint return with M for the year 1955 under sections 2 and 6013 (a). That part of the $15,000 distributive share attributable to the decedent for the period ending with the date of his death (January 1 through October 20, 1955) is income in respect of a decedent under section 691.

(4) *Disposition of less than entire interest.* If a partner sells or exchanges a part of his interest in a partnership, or if the interest of a partner is reduced, the partnership taxable year shall continue to its normal end. In such case, the partner's distributive share of items which he is required to include in his taxable income under the provisions of section 702 (a) shall be determined by taking into account his varying interests in the partnership during the partnership taxable year in which such sale, exchange, or reduction of interest occurred.

(5) *Transfer of interest by gift.* The transfer of a partnership interest by gift does not close the partnership taxable year with respect to the donor. However, the income up to the date of gift attributable to the donor's interest shall be allocated to him under section 704 (e) (2).

§ 1.707 Statutory provisions; transactions between partner and partnership.

SEC. 707. *Transactions between partner and partnership*—(a) *Partner not acting in capacity as partner.* If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

(b) *Certain sales or exchanges of property with respect to controlled partnerships*—(1) *Losses disallowed.* No deduction shall be allowed in respect of losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between—

(A) A partnership and a partner owning, directly or indirectly more than 50 percent of the capital interest, or the profits interest, in such partnership, or

(B) Two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

In the case of a subsequent sale or exchange by a transferee described in this paragraph, section 267 (d) shall be applicable as if the loss were disallowed under section 267 (a) (1).

(2) *Gains treated as ordinary income.* In the case of a sale or exchange, directly or indirectly, of property, which in the hands of the transferee, is property other than a capital asset as defined in section 1221—

(A) Between a partnership and a partner owning, directly or indirectly, more than 80 percent of the capital interest, or profits interest, in such partnership, or

(B) Between two partnerships in which the same persons own, directly or indirectly, more than 80 percent of the capital interests or profits interests,

any gain recognized shall be considered as gain from the sale or exchange of property other than a capital asset.

(3) *Ownership of a capital or profits interest.* For purposes of paragraphs (1) and (2) of this subsection, the ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules for constructive ownership of stock provided in section 267 (c) other than paragraph (3) of such section.

(c) *Guaranteed payments.* To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61 (a) (relating to gross income) and section 162 (a) (relating to trade or business expenses).

§ 1.707–1 Transactions between partner and partnership.

(a) *Partner not acting in capacity as partner.* A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money or property by the partnership to the partner or by the partner to the partnership, the sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partnership to the partner or by the partner to the partnership. Where a partner retains the ownership of property but allows the partnership to use such separately owned property for partnership purposes (for example, to obtain credit or to secure firm creditors by guaranty, pledge, or other agreement) the transaction is treated as one between a partnership and a partner not acting in his capacity as a partner. However, transfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not transactions included within the provisions of this section. In all cases, the substance of the transaction will govern rather than its form. See paragraph (c)(3) of § 1.731–1.

(b) *Certain sales or exchanges of property with respect to controlled partnerships*—(1) *Losses disallowed.* (i) No deduction shall be allowed for a loss on a sale or exchange of property (other than an interest in the partnership), directly or indirectly, between a partnership and a partner who owns, directly or indirectly, more than 50 percent of the capital interest or profits interest in such partnership. A loss on a sale or exchange of property, directly or indirectly, between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interest or profits interest in each partnership shall not be allowed.

(ii) If a gain is realized upon the subsequent sale or exchange by a transferee of property with respect to which a loss was disallowed under the provisions of subdivision (i) of this subparagraph, section 267 (d) (relating to amount of gain where loss previously disallowed) shall apply as though the loss were disallowed under section 267 (a) (1).

(2) *Gains treated as ordinary income.* Any gain recognized upon the sale or exchange, directly or indirectly, of property which, in the hands of the transferee immediately after the transfer, is property other than a capital asset, as defined in section 1221, shall be ordinary income if the transaction is between a partnership and a partner who owns, directly or indirectly, more than 80 percent of the capital interest or profits interest in the partnership. This rule also applies where such a transaction is between partnerships in which the same persons own, directly or indirectly, more than 80 percent of the capital interest or profits interest in each partnership. The term "property other than a capital asset" includes (but is not limited to) trade accounts receivable, inventory, stock in trade, and depreciable or real property used in the trade or business.

(3) *Ownership of a capital or profits interest.* In determining the extent of the ownership by a partner, as defined in section 761 (b), of his capital interest or profits interest in a partnership, the rules for constructive ownership of stock provided in section 267 (c) (1), (2), (4), and (5) shall be applied for the purpose of section 707 (b) and this paragraph. Under these rules, ownership of a capital or profits interest in a partnership may be attributed to a person who is not a partner as defined in section 761 (b) in order that another partner may be considered the constructive owner of such interest under section 267 (c). However, section 707 (b) (1) (A) does not apply to a constructive owner of a partnership interest since he is not a partner as defined in section 761 (b). For example, where trust T is a partner in the partnership ABT, and AW, A's wife, is the sole beneficiary of the trust, the ownership of a capital and profits interest in the partnership by T will be attributed to AW only for the purpose of further attributing the ownership of such interest to A. See section 267 (c) (1) and (5). If A, B, and T are equal partners, then A will be considered as owning more than 50 percent of the capital and profits interest in the partnership, and losses on transactions between him and the partnership will be disallowed by section 707 (b) (1) (A). However, a loss sustained by AW on a sale or exchange of property with the partnership would not be disallowed by section 707, but will be disallowed to the extent provided in paragraph (b) of § 1.267 (b)–1. See section 267 (a) and (b), and the regulations thereunder.

(c) *Guaranteed payments.* Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706 (a) and paragraph (a) of § 1.706–1. Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61 (a) (relating to gross income) and section 162 (a) (relating to trade or business expenses). They do not constitute an interest in partnership profits for purposes of sections 706 (b) (3), 707 (b), and 708 (b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105 (d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).

Example (2). Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

Example (3). Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner X, the XY partnership has a loss of $9,000. Of this amount, $2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704 (d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership.

Example (4). Assume the same facts as in example (3) of this paragraph, except that, instead of a $9,000 loss, the partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702 (a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X's 30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him.

§ 1.708 Statutory provisions; continuation of partnership.

SEC. 708. *Continuation of partnership*—(a) *General rule.* For purposes of this subchapter, an existing partnership shall be

considered as continuing if it is not terminated.

(b) *Termination*—(1) *General rule.* For purposes of subsection (a), a partnership shall be considered as terminated only if—

(A) No part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

(B) Within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

(2) *Special rules*—(A) *Merger or consolidation.* In the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.

(B) *Division of a partnership.* In the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) shall, for purposes of this section, be considered a continuation of the prior partnership.

§ 1.708–1 Continuation of partnership.

(a) *General rule.* For purposes of subchapter K, chapter 1 of the Code, an existing partnership shall be considered as continuing if it is not terminated.

(b) *Termination*—(1) *General rule.* (i) A partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. For example, on November 20, 1956, A and B, each of whom is a 20-percent partner in partnership ABC, sell their interests to C, who is a 60-percent partner. Since the business is no longer carried on by any of its partners in a partnership, the ABC partnership is terminated as of November 20, 1956. However, where partners DEF agree on April 30, 1957, to dissolve their partnership, but carry on the business through a winding up period ending September 30, 1957, when all remaining assets, consisting only of cash, are distributed to the partners, the partnership does not terminate because of cessation of business until September 30, 1957.

(*a*) Upon the death of one partner in a 2-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business.

(*b*) For the continuation of a partnership where payments are being made under section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest), see paragraph (a) (6) of § 1.736–1.

(ii) A partnership shall terminate when 50 percent or more of the total interest in partnership capital and profits is sold or exchanged within a period of 12 consecutive months. Such sale or exchange includes a sale or exchange to another member of the partnership. However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange for purposes of this subparagraph. Furthermore, the contribution of property to a partnership does not constitute such a sale or exchange. See, however, paragraph (c) (3) of § 1.731–1. Fifty percent or more of the total interest in partnership capital and profits means 50 percent or more of the total interest in partnership capital plus 50 percent or more of the total interest in partnership profits. Thus, the sale of a 30-percent interest in partnership capital and a 60-percent interest in partnership profits is not the sale or exchange of 50 percent or more of the total interest in partnership capital and profits. If one or more partners sell or exchange interests aggregating 50 percent or more of the total interest in partnership capital and 50 percent or more of the total interest in partnership profits within a period of 12 consecutive months, such sale or exchange is considered as being within the provisions of this subparagraph. When interests are sold or exchanged on different dates, the percentages to be added are determined as of the date of each sale. For example, with respect to the ABC partnership, the sale by A on May 12, 1956, of a 30-percent interest in capital and profits to D, and the sale by B on March 27, 1957, of a 30-percent interest in capital and profits to E, is a sale of a 50-percent or more interest. Accordingly, the partnership is terminated as of March 27, 1957. However, if, on March 27, 1957, D instead of B, sold his 30-percent interest in capital and profits to E, there would be no termination since only one 30-percent interest would have been sold or exchanged within a 12-month period.

(iii) For purposes of subchapter K, chapter 1 of the Code, a partnership taxable year closes with respect to all partners on the date on which the partnership terminates. See section 706(c) (1) and paragraph (c) (1) of § 1.706–1. The date of termination is:

(*a*) For purposes of section 708 (b) (1) (A), the date on which the winding up of the partnership affairs is completed.

(*b*) For purposes of section 708 (b) (1) (B), the date of the sale or exchange of a partnership interest which, of itself or together with sales or exchanges in the preceding 12 months, transfers an interest of 50 percent or more in both partnership capital and profits.

(iv) If a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership distributes its properties to the purchaser and the other remaining partners in proportion to their respective interests in the partnership properties; and, immediately thereafter, the purchaser and the other remaining partners contribute the properties to a new partnership, either for the continuation of the business or for its dissolution and winding up. In the latter case, the new partnership terminates in accordance with subdivision (i) of this subparagraph. See sections 731 and 732 and §§ 1.731–1 and 1 732–1. For election of basis adjustments by the purchaser and other remaining partners, see sections 732 (d) and 743 (b) and paragraph (d) of § 1.732–1 and paragraph (b) of § 1.743–1.

(2) *Special rules*—(i) *Merger or consolidation.* If two or more partnerships merge or consolidate into one partnership, the resulting partnership shall be considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership. If the resulting partnership can, under the preceding sentence, be considered a continuation of more than one of the merging or consolidating partnerships, it shall, unless the Commissioner permits otherwise, be considered the continuation of that partnership which is credited with the contribution of the greatest dollar value of assets to the resulting partnership. Any other merging or consolidating partnerships shall be considered as terminated. If the members of none of the merging or consolidating partnerships have an interest of more than 50 percent in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results. The taxable years of such merging or consolidating partnerships which are considered terminated shall be closed in accordance with the provisions of section 706 (c), and such partnerships shall file their returns for a taxable year ending upon the date of termination, i. e., the date of merger or consolidation. The resulting partnership shall file a return for the taxable year of the merging or consolidating partnership that is considered as continuing. The return shall state that the resulting partnership is a continuation of such merging or consolidating partnership and shall include the names and addresses of the merged or consolidated partnerships. The respective distributive shares of the partners for the periods prior to and subsequent to the date of merger or consolidation shall be shown as a part of the return. The provisions of this subdivision may be illustrated by the following example:

Example. Partnership AB, in whose capital and profits A and B each own a 50-percent interest, and partnership CD, in whose capital and profits C and D each own a 50-percent interest, merge on September 30, 1955, and form partnership ABCD. Partners A, B, C, and D are on a calendar year; partnership AB is also on a calendar year; and partnership CD is on a fiscal year ending June 30th. After the merger, the partners have capital and profits interests as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent. Since A and B together own an interest of more than 50 percent in the capital and profits of partnership ABCD, such partnership shall be considered a continuation of partnership AB and shall continue to file returns on a calendar year basis. Since C and D own an interest of less than 50 percent in the capital and profits of partnership ABCD, the taxable year of partnership CD closes as of September 30, 1955, the date of the merger, and CD partnership is terminated as of that date. Partnership ABCD is required to file a return for the taxable year January 1 to December 31, 1955, indicating thereon that, until September 30, 1955, it was partnership AB. Partnership CD is required to file a

return for its final taxable year, July 1 through September 30, 1955.

(ii) *Division of a partnership.* Upon the division of a partnership into two or more partnerships, any resulting partnership or partnerships shall be considered a continuation of the prior partnership if its members had an interest of more than 50 percent in the capital and profits of the prior partnership. Any other resulting partnership will not be considered a continuation of the prior partnership but will be considered a new partnership. If the members of none of the resulting partnerships owned an interest of more than 50 percent in the capital and profits of the divided partnership, the divided partnership is terminated. Where members of a partnership which has been divided into two or more partnerships do not become members of a resulting partnership which is considered a continuation of the prior partnership, such partner's interests shall be considered liquidated as of the date of the division. The resulting partnership that is regarded as continuing shall file a return for the taxable year of the partnership that has been divided. The return shall state that the partnership is a continuation of the divided partnership and shall set forth separately the respective distributive shares of the partners for the periods prior to and subsequent to the date of division. The provisions of this subdivision may be illustrated by the following example:

Example. Partnership ABCD is in the real estate and insurance business. A owns a 10-percent interest, and B, C, and D each owns a 20-percent interest, in the capital and profits of the partnership. The partnership and the partners report their income on a calendar year. They agree to separate the real estate and insurance business as of November 1, 1955, and to form two partnerships; partnership AB to take over the real estate business, and partnership CD to take over the insurance business. Since members of resulting partnership AB owned more than a 50-percent interest in the capital and profits of partnership ABCD (A, 40 percent, and B, 20 percent), partnership AB shall be considered a continuation of partnership ABCD. Partnership AB is required to file a return for the taxable year January 1 to December 31, 1955, indicating thereon that until November 1, 1955, it was partnership ABCD. In forming partnership CD, partners C and D may contribute the property distributed to them in liquidation of their entire interests in divided partnership ABCD. Partnership CD will be required to file a return for the taxable year it adopts pursuant to section 706 (b) and paragraph (b) of § 1.706–1.

CONTRIBUTIONS, DISTRIBUTIONS, AND TRANSFERS

CONTRIBUTIONS TO A PARTNERSHIP

§ 1.721 Statutory provisions; nonrecognition of gain or loss on contribution.

SEC. 721. *Nonrecognition of gain or loss on contribution.* No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

§ 1.721–1 Nonrecognition of gain or loss on contribution.

(a) No gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property, including installment obligations, to the partnership in exchange for a partnership interest. This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating. Section 721 shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by section 707. Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. See paragraph (c) (3) of § 1.731–1. Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721. For the rules governing the treatment of liabilities to which contributed property is subject, see section 752 and § 1.752–1.

(b) (1) Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

(2) To the extent that the value of such interest is: (i) compensation for services rendered to the partnership, it is a guaranteed payment for services under section 707 (c); (ii) compensation for services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter.

§ 1.722 Statutory provisions; basis of contributing partner's interest.

SEC. 722. *Basis of contributing partner's interest.* The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution.

§ 1.722–1 Basis of contributing partner's interest.

The basis to a partner of a partnership interest acquired by a contribution of property, including money, to the partnership shall be the amount of money contributed plus the adjusted basis at the time of contribution of any property contributed. If the acquisition of an interest in partnership capital results in taxable income to a partner, such income shall constitute an addition to the basis of the partner's interest. See paragraph (b) of § 1.721–1. If the contributed property is subject to indebtedness or if liabilities of the partner are assumed by the partnership, the basis of the contributing partner's interest shall be reduced by the portion of the indebtedness assumed by the other partners, since the partnership's assumption of his indebtedness is treated as a distribution of money to the partner. Conversely, the assumption by the other partners of a portion of the contributor's indebtedness is treated as a contribution of money by them. See section 752 and § 1.752–1. The provisions of this section may be illustrated by the following examples:

Example (1). A acquired a 20-percent interest in a partnership by contributing property. At the time of A's contribution, the property had a fair market value of $10,000, an adjusted basis to A of $4,000, and was subject to a mortgage of $2,000. Payment of the mortgage was assumed by the partnership. The basis of A's interest in the partnership is $2,400, computed as follows:

Adjusted basis to A of property contributed	$4,000
Less portion of mortgage assumed by other partners which must be treated as a distribution (80 percent of $2,000)	1,600
Basis of A's interest	2,400

Example (2). If, in example (1) of this section, the property contributed by A was subject to a mortgage of $6,000, the basis of A's interest would be zero, computed as follows:

Adjusted basis to A of property contributed	$4,000
Less portion of mortgage assumed by other partners which must be treated as a distribution (80 percent of $6,000)	4,800
	(800)

Since A's basis cannot be less than zero, the $800 in excess of basis, which is considered as a distribution of money under section 752 (b), is treated as capital gain from the sale or exchange or a partnership interest. See section 731 (a).

§ 1.723 Statutory provisions; basis of property contributed to partnership.

SEC. 723. *Basis of property contributed to partnership.* The basis of property contrib-

uted to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution.

§ 1.723–1 Basis of property contributed to partnership.

The basis to the partnership of property contributed to it by a partner is the adjusted basis of such property to the contributing partner at the time of the contribution. Since such property has the same basis in the hands of the partnership as it had in the hands of the contributing partner, the holding period of such property for the partnership includes the period during which it was held by the partner. See section 1223 (2). For elective adjustments to the basis of partnership property arising from distributions or transfers of partnership interests, see sections 732 (d), 734 (b), and 743 (b).

DISTRIBUTIONS BY A PARTNERSHIP

§ 1.731 Statutory provisions; extent of recognition of gain or loss on distribution.

SEC. 731. *Extent of recognition of gain or loss on distribution*—(a) *Partners.* In the case of a distribution by a partnership to a partner—

(1) Gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and

(2) Loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of—

(A) Any money distributed, and

(B) The basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751 (c)) and inventory (as defined in section 751 (d) (2)).

Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

(b) *Partnerships.* No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.

(c) *Exceptions.* This section shall not apply to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest) and section 751 (relating to unrealized receivables and inventory items).

§ 1.731–1 Extent of recognition of gain or loss on distribution.

(a) *Recognition of gain or loss to partner*—(1) *Recognition of gain.* (i) Where money is distributed by a partnership to a partner, no gain shall be recognized to the partner except to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. This rule is applicable both to current distributions (i. e., distributions other than in liquidation of an entire interest) and to distributions in liquidation of a partner's entire interest in a partnership. Thus, if a partner with a basis for his interest of $10,000 receives a distribution of cash of $8,000 and property with a fair market value of $3,000, no gain is recognized to him. If $11,000 cash were distributed, gain would be recognized to the extent of $1,000. No gain shall be recognized to a distributee partner with respect to a distribution of property (other than money) until he sells or otherwise disposes of such property, except to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest) and section 751 (relating to unrealized receivables and inventory items). See section 731 (c) and paragraph (c) of this section.

(ii) For the purposes of sections 731 and 705, advances or drawings of money or property against a partner's distributive share of income shall be treated as current distributions made on the last day of the partnership taxable year with respect to such partner.

(2) *Recognition of loss.* Loss is recognized to a partner only upon liquidation of his entire interest in the partnership, and only if the property distributed to him consists solely of money, unrealized receivables (as defined in section 751 (c)), and inventory items (as defined in section 751 (d) (2)). The term "liquidation of a partner's interest", as defined in section 761 (d), is the termination of the partner's entire interest in the partnership by means of a distribution or a series of distributions. Loss is recognized to the distributee partner in such cases to the extent of the excess of the adjusted basis of such partner's interest in the partnership at the time of the distribution over the sum of—

(i) Any money distributed to him, and

(ii) The basis to the distributee, as determined under section 732, of any unrealized receivables and inventory items that are distributed to him.

If the partner whose interest is liquidated receives any property other than money, unrealized receivables, or inventory items, then no loss will be recognized. Application of the provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner A has a partnership interest in partnership ABC with an adjusted basis to him of $10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $5,000 cash and inventory with a basis to him (under section 732) of $3,000. Partner A realizes a capital loss of $2,000, which is recognized under section 731 (a) (2).

Example (2). Partner B has a partnership interest in partnership BCD with an adjusted basis to him of $10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $4,000 cash, real property (used in the trade or business) with an adjusted basis to the partnership of $2,000, and unrealized receivables having a basis to him (under section 732) of $3,000. No loss will be recognized to B on the transaction because he received property other than money, unrealized receivables, and inventory items. As determined under section 732, the basis to B for the real property received is $3,000.

(3) *Character of gain or loss.* Gain or loss recognized under section 731 (a) on a distribution is considered gain or loss from the sale or exchange of the partnership interest of the distributee partner, that is, capital gain or loss.

(b) *Gain or loss recognized by partnership.* A distribution of property (including money) by a partnership to a partner does not result in recognized gain or loss to the partnership under section 731. However, recognized gain or loss may result to the partnership from certain distributions which, under section 751 (b), must be treated as a sale or exchange of property between the distributee partner and the partnership.

(c) *Exceptions.* (1) Section 731 does not apply to the extent otherwise provided by—

(i) Section 736 (relating to payments to a retiring partner or to a deceased partner's successor in interest) and

(ii) Section 751 (relating to unrealized receivables and inventory items).

For example, payments under section 736 (a), which are considered as a distributive share or guaranteed payment, are taxable as such under that section.

(2) The receipt by a partner from the partnership of money or property under an obligation to repay the amount of such money or to return such property does not constitute a distribution subject to section 731 but is a loan governed by section 707 (a). To the extent that such an obligation is canceled, the obligor partner will be considered to have received a distribution of money or property at the time of cancellation.

(3) If there is a contribution of property to a partnership and within a short period:

(i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or

(ii) After such contribution the contributed property is distributed to another partner,

such distribution may not fall within the scope of section 731. Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner. Such a transaction shall be treated as an exchange of property.

§ 1.732 Statutory provisions; basis of distributed property other than money.

SEC. 732. *Basis of distributed property other than money*—(a) *Distributions other than in liquidation of a partner's interest*—(1) *General rule.* The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall, except as provided in paragraph (2), be its adjusted basis to the partnership immediately before such distribution.

(2) *Limitation.* The basis to the distributee partner of property to which paragraph (1) is applicable shall not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(b) *Distribution in liquidation.* The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(c) *Allocation of basis.* The basis of distributed properties to which subsection (a) (2) or subsection (b) is applicable shall be allocated—

(1) First to any unrealized receivables (as defined in section 751 (c)) and inventory items (as defined in section 751 (d) (2)) in an amount equal to the adjusted basis of each such property to the partnership (or if the basis to be allocated is less than the sum of the adjusted bases of such properties to the partnership, in proportion to such bases), and

(2) To the extent of any remaining basis, to any other distributed properties in proportion to their adjusted bases to the partnership.

(d) *Special partnership basis to transferee.* For purposes of subsections (a), (b), and (c), a partner who acquired all or a part of his interest by a transfer with respect to which the election provided in section 754 is not in effect, and to whom a distribution of property (other than money) is made with respect to the transferred interest within 2 years after such transfer, may elect, under regulations prescribed by the Secretary or his delegate, to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in section 743 (b) were in effect with respect to the partnership property. The Secretary or his delegate may by regulations require the application of this subsection in the case of a distribution to a transferee partner, whether or not made within 2 years after the transfer, if at the time of the transfer the fair market value of the partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.

(e) *Exception.* This section shall not apply to the extent that a distribution is treated as a sale or exchange of property under section 751 (b) (relating to unrealized receivables and inventory items).

§ 1.732–1 Basis of distributed property other than money.

(a) *Distributions other than in liquidation of a partner's interest.* The basis of property (other than money) received by a partner in a distribution from a partnership, other than in liquidation of his entire interest, shall be its adjusted basis to the partnership immediately before such distribution. However, the basis of the property to the partner shall not exceed the adjusted basis of the partner's interest in the partnership, reduced by the amount of any money distributed to him in the same transaction. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Partner A, with an adjusted basis of $15,000 for his partnership interest, receives in a current distribution property having an adjusted basis of $10,000 to the partnership immediately before distribution, and $2,000 cash. The basis of the property in A's hands will be $10,000. Under sections 733 and 705, the basis of A's partnership interest will be reduced by the distribution to $3,000 ($15,000, less $2,000 cash, less $10,000, the basis of the distributed property to A).

Example (2). Partner R has an adjusted basis of $10,000 for his partnership interest. He receives a current distribution of $4,000 cash and property with an adjusted basis to the partnership of $8,000. The basis of the distributed property to partner R is limited to $6,000 ($10,000, the adjusted basis of his interest, reduced by $4,000, the cash distributed).

(b) *Distribution in liquidation.* Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him in the same transaction. Application of this rule may be illustrated by the following example:

Example. Partner B, with a partnership interest having an adjusted basis to him of $12,000, retires from the partnership and receives cash of $2,000, and real property with an adjusted basis to the partnership of $6,000 and a fair market value of $14,000. The basis of the real property to B is $10,000 (B's basis for his partnership interest, $12,000, reduced by $2,000, the cash distributed).

(c) *Allocation of basis among properties distributed to a partner.* (1) Under section 732 (a) (2) or (b), the basis to be allocated to properties distributed to a partner shall be allocated first to any unrealized receivables (as defined in section 751 (c)) and inventory items (as defined in section 751 (d) (2)) included in the distribution. However, such receivables or inventory items may not take a higher basis in the hands of the partner than their common adjusted basis to the partnership immediately before the distribution, unless such distribution is treated as a sale or exchange under section 751 (b), or unless the distributee partner has a special basis adjustment for the distributed property under sections 732 (d) or 743 (b). Any basis not allocated to unrealized receivable or inventory items shall be allocated to any other properties distributed to the partner in the same transaction, in proportion to the bases of such other properties in the hands of the partnership before distribution. The provisions of this subparagraph may be illustrated by the following example:

Example. Partner A, whose partnership interest in partnership ABC has an adjusted basis of $15,000, receives as a distribution in liquidation of his entire interest inventory items having a basis to the partnership of $6,000. In addition, he receives cash of $5,000, and two parcels of real property with adjusted bases to the partnership of $6,000 and $2,000, respectively. Basis in the amount of $10,000 ($15,000 basis, less $5,000 cash received) is allocated $6,000 to inventory items, and $3,000 (6,000/8,000 x $4,000) and $1,000 (2,000/8,000 x $4,000), respectively, to the two parcels of real property.

(2) If the adjusted basis to the partnership of the unrealized receivables and inventory items distributed to a partner is greater than the partner's adjusted basis of his interest (reduced by the amount of money distributed to him in the same transaction), the amount of the basis to be allocated to such unrealized receivables and inventory items shall be allocated in proportion to the adjusted bases of such properties in the hands of the partnership. If the basis of the partner's interest to be allocated upon a distribution in liquidation of his entire interest is in excess of the adjusted basis to the partnership of the unrealized receivables and inventory items distributed, and if there is no other property distributed to which such excess can be allocated, the distributee partner sustains a capital loss under section 731 (a) (2) to the extent of the unallocated basis of his partnership interest. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner C, whose interest in partnership ABC has an adjusted basis to him of $9,000, receives as a distribution in liquidation cash of $6,000, inventory items having an adjusted basis to the partnership of $6,000, and real property having a basis to the partnership of $4,000. The cash payment reduces C's basis to $3,000, which is allocated entirely to inventory items. The real property has a zero basis in C's hands. The partnership bases not carried over to C for the distributed properties are lost unless an election under section 754 is in effect requiring the partnership to adjust the bases of remaining partnership properties under section 734 (b).

Example (2). Partner B, whose interest in partnership ABC has an adjusted basis to him of $9,000, receives as a distribution in liquidation cash of $1,000 and inventory items having a basis to the partnership of $6,000. The cash payment reduces B's basis to $8,000, which can be allocated only to the extent of $6,000 to the inventory items. The remaining $2,000 basis, not allocable to distributed property, constitutes a capital loss in that amount to partner B under section 731 (a) (2). If the election under section 754 is in effect, see section 734 (b) for adjustment of the basis of undistributed partnership property.

(d) *Special partnership basis to transferee under section 732 (d).* (1) (i) A transfer of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner. Section 732 (d) provides a special rule for the determination of the basis of property distributed to a transferee partner who acquired any part of his partnership interest in a transfer with respect to which the election under section 754 (relating to the optional adjustment to basis of partnership property) was not in effect.

(ii) Where an election under section 754 is in effect, see section 743 (b) and paragraph (b) of § 1.743–1 and § 1.732–2.

(iii) If a transferee partner receives a distribution of property (other than money) from the partnership within 2 years after he acquired his interest or part thereof in the partnership by a transfer with respect to which the election under section 754 was not in effect, he may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in section 743 (b) were in effect.

(iv) If an election under section 732 (d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation of that portion of the basis of partnership property which arises from the special basis adjustment under section 732 (d), since depletion or depreciation on such portion

for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743 (b) is in effect.

(v) If property is distributed to a transferee partner who elects under section 732(d), and if such property is not the same property which would have had a special basis adjustment, then such special basis adjustment shall apply to any like property received in the distribution, provided that the transferee, in exchange for the property distributed, has relinquished his interest in the property with respect to which he would have had a special basis adjustment. This rule applies whether the property in which the transferee has relinquished his interest is retained or disposed or by the partnership. (For shift of transferee's special basis adjustment to like property, see paragraph (b) (2) (ii) of § 1.743–1.)

(vi) The provisions of this subparagraph may be illustrated by the following example:

Example. The basis to transferee partner K of his one-fourth interest in partnership WJKS is $17,000. At the time he acquired such interest by purchase, the election under section 754 was not in effect and the partnership inventory had a basis to the partnership of $14,000 and a value of $16,000. K's purchase price reflected $500 of this difference. Thus, $4,000 of the $17,000 paid by K for his one-fourth interest was attributable to his share of partnership inventory with a basis of $3,500. Within 2 years after acquiring his interest, K retired from the partnership and received in liquidation of his entire interest cash of $1,500, inventory with a basis to the partnership of $3,500, property X (a capital asset), with an adjusted basis to the partnership of $2,000, and property Y (a depreciable asset), with an adjusted basis to the partnership of $4,000. The value of the inventory received by K was one-fourth of the value of all partnership inventory and was his share of such property. It is immaterial whether the inventory K received was on hand when K acquired his interest. In accordance with K's election under section 732 (d), the amount of his share of partnership basis which is attributable to partnership inventory is increased by $500 (one-fourth of the $2,000 difference between the value of such property, $16,000, and its $14,000 basis to the partnership at the time K acquired his interest). This adjustment under section 732 (d) applies only for purposes of distributions to partner K, and not for purposes of partnership depreciation, depletion, or gain or loss on disposition. Thus, the amount to be allocated among the properties received by K in the liquidating distribution is $15,500 ($17,000, K's basis for his interest, reduced by the amount of cash received, $1,500). This amount is allocated as follows: The basis of the inventory items received is $4,000, consisting of the $3,500 common partnership basis for such items, plus the special basis adjustment of $500 which K would have had under section 743 (b). The remaining basis of $11,500 ($15,500 minus $4,000) is to be allocated to the remaining property distributed to K in proportion to their adjusted bases to the partnership. Since the adjusted basis to the partnership of property X is $2,000, and that of property Y is $4,000, the $11,500 is allocated $3,833 (2,000/6,000×$11,500) to X, and $7,667 (4,000/6,000×$11,500) to Y.

(2) A transferee partner who wishes to elect under section 732 (d) shall make the election with his tax return—

(i) For the year of the distribution, if the distribution includes any property subject to the allowance for depreciation, depletion, or amortization, or

(ii) For any taxable year no later than the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax, if the distribution does not include any such property subject to the allowance for depreciation, depletion or amortization.

(3) A taxpayer making an election under section 732 (d) shall submit with the return in which the election is made a schedule setting forth the following:

(i) That under section 732 (d) he elects to adjust the basis of property received in a distribution; and

(ii) The computation of the special basis adjustment for the property distributed and the properties to which the adjustment has been allocated. For rules of allocation, see section 755.

(4) A partner who acquired any part of his partnership interest in a transfer to which the election provided in section 754 was not in effect, is required to apply the special basis rule contained in section 732 (d) to a distribution to him, whether or not made within 2 years after the transfer, if at the time of his acquisition of the transferred interest—

(i) The fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership,

(ii) An allocation of basis under section 732 (c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance, and

(iii) A special basis adjustment under section 743 (b) would change the basis to the transferee partner of the property actually distributed.

The application of the rule presented in this subparagraph may be illustrated by the following examples:

Example (1). Partnership ABC owns three parcels of land, each of which has an adjusted basis to the partnership of $5,000 and is worth $55,000, and depreciable property with an adjusted basis and value of $150,000. D purchases A's partnership interest for $105,000 when the election under section 754 is not in effect. At the time of D's purchase, the fair market value of all partnership property (other than money) is $315,000, which exceeds 110 percent of $165,000, its adjusted basis to the partnership. Four years later, the partnership is dissolved. D receives one of the three parcels of land which has a basis to the partnership of $5,000, and one-third of the depreciable property with an adjusted basis to the partnership at that time of $45,000, one-third of $135,000 ($150,000 basis, minus $15,000 depreciation computed on the partnership basis. See subparagraph (1) (iv) of this paragraph.) If D's adjusted basis for his interest at the time of the distribution was $100,000 and was allocated under section 732 (c) to the property received by him in proportion to their respective bases to the partnership, the basis to him for the distributed land would be $10,000 (5,000/50,000×$100,000) and the basis of the depreciable property would be $90,000 (45,000/50,000×$100,000). In effect, D would be attributing to the basis of the depreciable property a portion of the cost of his partnership interest properly attributable to appreciation in nondepreciable property. The application of section 743 (b) to the transfer of the interest would have resulted in a different basis to D for the property actually distributed. Therefore, the special basis adjustment under section 732 (d) must be made so that D must increase the basis of the land by a special basis adjustment of $50,000 ($55,000 fair market value less $5,000 partnership basis), making the basis of his interest therein $55,000 (55,000/100,000×$100,000). D's basis for the depreciable property will then be $45,000 (45,000/100,000×$100,000).

Example (2). Assume the same facts as in example (1) of this subparagraph, except that the partnership does not dissolve but distributes one parcel of land to each of the partners in a current distribution. Since the conditions of this subparagraph have been met, D's basis for the distributed land is the adjusted basis such land would have if the adjustment provided in section 743 (b) were in effect with respect to the partnership property. Therefore, D's basis for the land is $55,000 ($5,000 basis of the land to the partnership, plus $50,000 special basis adjustment under section 732 (d)). D's basis for his partnership interest is reduced by $55,000, his basis for the property distributed.

(e) *Exception.* When a partnership distributes unrealized receivables (as defined in section 751 (c)) or substantially appreciated inventory items (as defined in section 751 (d)) in exchange for any part of a partner's interest in other partnership property (including money), or, conversely, partnership property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, the distribution will be treated as a sale or exchange of property under the provisions of section 751 (b). In such case, section 732 (including subsection (d) thereof) applies in determining the partner's basis of the property which he is treated as having sold to or exchanged with the partnership (as constituted after the distribution). The partner is considered as having received such property in a current distribution and paragraph (b) of § 1.751–1. However, section 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by him in a sale or exchange under section 751 (b). Consequently, the basis of such property shall be its cost to the partner.

§ 1.732–2 Special partnership basis of distributed property.

(a) *Adjustments under section 734(b).* In the case of a distribution of property to a partner, the partnership bases of the distributed properties shall reflect any increases or decreases to the basis of partnership property which have been made previously under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) in connection with previous distributions.

(b) *Adjustments under section 743 (b).* In the case of a distribution of property to a partner who acquired any part of his interest in a transfer as to which an election under section 754 was in effect, then, for the purposes of section 732 (other than subsection (d) thereof), the adjusted partnership bases

of the distributed property shall take into account, in addition to any adjustments under section 734(b), the transferee's special basis adjustment for the distributed property under section 743 (b). The application of this paragraph may be illustrated by the following example:

Example. Partner D acquired his interest in partnership ABD from a previous partner. Since the partnership had made an election under section 754, a special basis adjustment with respect to D is applicable to the basis of partnership property in accordance with section 743 (b). One of the assets of the partnership at the time D acquired his interest was property X, which is later distributed to D in a current distribution. Property X has an adjusted basis to the partnership of $1,000 and with respect to D it has a special basis adjustment of $500. Therefore, for purposes of section 732 (a) (1), the adjusted basis of such property to the partnership with respect to D immediately before its distribution is $1,500. However, if property X is distributed to partner A, a nontransferee partner, its adjusted basis to the partnership for purposes of section 732 (a) (1) is only $1,000. In such case, D's $500 special basis adjustment may shift over to other property. See paragraph (b) (2) (ii) of § 1.743–1.

(c) *Adjustments to basis of distributed inventory and unrealized receivables.* Under section 732, the basis to be allocated to distributed properties shall be allocated first to any unrealized receivables and inventory items. If the distributee partner is a transferee of a partnership interest and has a special basis adjustment for unrealized receivables or inventory items under either section 743 (b) or section 732 (d), then the partnership adjusted basis immediately prior to distribution of any unrealized receivables or inventory items distributed to such partner shall be determined as follows: If the distributee partner receives his entire share of the fair market value of the inventory items or unrealized receivables of the partnership, the adjusted basis of such distributed property to the partnership, for the purposes of section 732, shall take into account the entire amount of any special basis adjustment which the distributee partner may have for such assets. If the distributee partner receives less than his entire share of the fair market value of partnership inventory items or unrealized receivables, then, for purposes of section 732, the adjusted basis of such distributed property to the partnership shall take into account the same proportion of the distributee's special basis adjustment for unrealized receivables or inventory items as the value of such items distributed to him bears to his entire share of the total value of all such items of the partnership. The provisions of this paragraph may be illustrated by the following example:

Example. Partner C acquired his 40-percent interest in partnership AC from a previous partner. Since the partnership had made an election under section 754, C has a special basis adjustment to partnership property under section 743 (b). C retires from the partnership when the adjusted basis of his partnership interest is $3,000. He receives from the partnership in liquidation of his entire interest, $1,000 cash, certain capital assets, depreciable property, and certain inventory items and unrealized receivables. C has a special basis adjustment of $800 with respect to partnership inventory items and of $200 with respect to unrealized receivables. The common partnership basis for the inventory items distributed to him is $500 and for the unrealized receivables is zero. If the value of inventory items and the unrealized receivables distributed to C in his 40 percent share of the total value of all partnership inventory items and unrealized receivables, then, for purposes of section 732, the adjusted basis of such property in C's hands will be $1,300 for the inventory items ($500 plus $800) and $200 for the unrealized receivables (zero plus $200). The remaining basis of $500, which constitutes the basis of the capital assets and depreciable property distributed to C, is determined as follows: $3,000 (total basis) less $1,000 cash, or $2,000 (the amount to be allocated to the basis of all distributed property), less $1,500 ($800 and $200 special basis adjustments, plus $500 common partnership basis, the amount allocated to inventory items and unrealized receivables). However, if the value of the inventory items and unrealized receivables distributed to C consisted of only 20 percent of the total fair market value of such property (i. e., only one-half of C's 40-percent share), then only one-half of C's special basis adjustment of $800 for partnership inventory items and $200 for unrealized receivables would be taken into account. In that case, the basis of the inventory items in C's hands would be $650 ($250, the common partnership basis for inventory items distributed to him, plus $400, one-half of C's special basis adjustment for inventory items). The basis of the unrealized receivables in C's hands would be $100 (zero plus $100, one-half of C's special basis adjustment for unrealized receivables).

§ 1.733 Statutory provisions; basis of distributee partner's interest.

SEC. 733. *Basis of distributee partner's interest.* In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by—

(1) The amount of any money distributed to such partner, and

(2) The amount of the basis to such partner of distributed property other than money, as determined under section 732.

§ 1.733–1 Basis of distributee partner's interest.

In the case of a distribution by a partnership to a partner other than in liquidation of a partner's entire interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by the amount of any money distributed to such partner and by the amount of the basis to him of distributed property other than money as determined under section 732 and §§ 1.732–1 and 1.732–2.

§ 1.734 Statutory provisions; optional adjustment to basis of undistributed partnership property.

SEC. 734. *Optional adjustment to basis of undistributed partnership property*—(a) *General rule.* The basis of partnership property shall not be adjusted as the result of a distribution of property to a partner unless the election, provided in section 754 (relating to optional adjustment to basis of partnership property), is in effect with respect to such partnership.

(b) *Method of adjustment.* In the case of a distribution of property to a partner, a partnership, with respect to which the election provided in section 754 is in effect, shall—

(1) Increase the adjusted basis of partnership property by—

(A) The amount of any gain recognized to the distributee partner with respect to such distribution under section 731 (a) (1), and

(B) In the case of distributed property to which section 732 (a) (2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732 (d)) over the basis of the distributed property to the distributee, as determined under section 732, or

(2) Decrease the adjusted basis of partnership property by—

(A) The amount of any loss recognized to the distributee partner with respect to such distribution under section 731 (a) (2), and

(B) In the case of distributed property to which section 732 (b) applies, the excess of the basis of the distributed property to the distributee, as determined under section 732, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by section 732 (d)).

(c) *Allocation of basis.* The allocation of basis among partnership properties where subsection (b) is applicable shall be made in accordance with the rules provided in section 755.

§ 1.734–1 Optional adjustment to basis of undistributed partnership property.

(a) *General rule.* A partnership shall not adjust the basis of partnership property as the result of a distribution of property to a partner, unless the election provided in section 754 (relating to optional adjustment to basis of partnership property) is in effect.

(b) *Method of adjustment*—(1) *Increase in basis.* Where an election under section 754 is in effect and a distribution of partnership property is made, whether or not in liquidation of the partner's entire interest in the partnership, the adjusted basis of the remaining partnership assets shall be increased by—

(i) The amount of any gain recognized under section 731 (a) (1) to the distributee partner, or

(ii) The excess of the adjusted basis to the partnership immediately before the distribution of any property distributed (including adjustments under section 743 (b) or section 732 (d) when applied) over the basis under section 732 (including such special basis adjustments) of such property to the distributee partner.

The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner A has a basis of $10,000 for his one-third interest in partnership ABC. The partnership has no liabilities and has assets consisting of cash of $11,000 and property with a partnership basis of $19,000 and a value of $22,000. A receives $11,000 in cash in liquidation of his entire interest in the partnership. He has a gain of $1,000 under section 731 (a) (1). If the election under section 754 is in effect, the partnership basis for the property becomes $20,000 ($19,000 plus $1,000).

Example (2). Partner D has a basis of $10,000 for his one-third interest in partnership DEF. The partnership balance sheet before the distribution shows the following:

ASSETS

	Adjusted basis	Value
Cash	$4,000	$4,000
Property X	11,000	11,000
Property Y	15,000	18,000
Total	30,000	33,000

LIABILITIES AND CAPITAL

Liabilities	$0	$0
Capital:		
D	10,000	11,000
E	10,000	11,000
F	10,000	11,000
Total	30,000	33,000

In liquidation of his entire interest in the partnership, D received property X with a partnership basis of $11,000. D's basis for property X is $10,000 under section 732 (b). Where the election under section 754 is in effect, the excess of $1,000 (the partnership basis before the distribution less D's basis for property X after distribution) is added to the basis of property Y. The basis of property Y becomes $16,000 ($15,000 plus $1,000). If the distribution is made to a transferee partner who elects under section 732 (d), see § 1.734–2.

(2) *Decrease in basis.* Where the election provided in section 754 is in effect and a distribution is made in liquidation of a partner's entire interest, the partnership shall decrease the adjusted basis of the remaining partnership property by—

(i) The amount of loss, if any, recognized under section 731(a)(2) to the distributee partner, or

(ii) The excess of the basis of the distributed property to the distributee, as determined under section 732 (including adjustments under section 743(b) or section 732(d) when applied) over the adjusted basis of such property to the partnership (including such special basis adjustments) immediately before such distribution.

The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner G has a basis of $11,000 for his one-third interest in partnership GHI. Partnership assets consist of cash of $10,000 and property with a basis of $23,000 and a value of $20,000. There are no partnership liabilities. In liquidation of his entire interest in the partnership, G receives $10,000 in cash. He has a loss of $1,000 under section 731 (a) (2). If the election under section 754 is in effect, the partnership basis for the property becomes $22,000 ($23,000 less $1,000).

Example (2). Partner J has a basis of $11,000 for his one-third interest in partnership JKL. The partnership balance sheet before the distribution shows the following:

ASSETS

	Adjusted basis	Value
Cash	$5,000	$5,000
Property X	10,000	10,000
Property Y	18,000	15,000
Total	33,000	30,000

LIABILITIES AND CAPITAL

Liabilities	$0	$0
Capital:		
J	11,000	10,000
K	11,000	10,000
L	11,000	10,000
Total	33,000	30,000

In liquidation of his entire interest in the partnership, J receives property X with a partnership basis of $10,000. J's basis for property X under section 732 (b) is $11,000. Where the election under section 754 is in effect, the excess of $1,000 ($11,000 basis of property X to J, the distributee, less its $10,000 adjusted basis to the partnership immediately before the distribution) decreases the basis of property Y in the partnership. Thus, the basis of property Y becomes $17,000 ($18,000 less $1,000). If the distribution is made to a transferee partner who elects under section 732 (d), see § 1.734–2.

(c) *Allocation of basis.* For allocation among the partnership properties of basis adjustments under section 734 (b) and paragraph (b) of this section, see section 755 and § 1.755–1.

(d) *Returns.* A partnership which must adjust the bases of partnership properties under section 734 shall attach a statement to the partnership return for the year of the distribution setting forth the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

§ 1.734–2 Adjustment after distribution to transferee partner.

(a) In the case of a distribution of property by the partnership to a partner who has obtained all or part of his partnership interest by transfer, the adjustments to basis provided in section 743(b) and section 732(d) shall be taken into account in applying the rules under section 734(b). For determining the adjusted basis of distributed property to the partnership immediately before the distribution where there has been a prior transfer of a partnership interest with respect to which the election provided in section 754 or section 732(d) is in effect, see §§ 1.732–1 and 1.732–2.

(b) (1) If a transferee partner, in liquidation of his entire partnership interest, receives a distribution of property (including money) with respect to which he has no special basis adjustment, in exchange for his interest in property with respect to which he has a special basis adjustment, and does not utilize his entire special basis adjustment in determining the basis of the distributed property to him under section 732, the unused special basis adjustment of the distributee shall be applied as an adjustment to the partnership basis of the property retained by the partnership and as to which the distributee did not use his special basis adjustment. The provisions of this subparagraph may be illustrated by the following example:

Example. Upon the death of his father, partner S acquires by inheritance a half-interest in partnership ACS. Partners A and C each have a one-quarter interest. The assets of the partnership consist of $10,000 cash and land used in farming worth $10,000 with a basis of $1,000 to the partnership. Since the partnership had made the election under section 754 at the time of transfer, partner S had a special basis adjustment of $4,500 under section 743 (b) with respect to his undivided half-interest in the real estate. The basis of S's partnership interest, in accordance with section 742, is $10,000. S retires from the partnership and receives $10,000 in cash in exchange for his entire interest. Since S has received no part of the real estate, his special basis adjustment of $4,500 will be allocated to the real estate, the remaining partnership property, and will increase its basis to the partnership to $5,500.

(2) The provisions of this paragraph do not apply to the extent that certain distributions are treated as sales or exchanges under section 751 (b) (relating to unrealized receivables and substantially appreciated inventory items). See section 751 (b) and paragraph (b) of § 1.751–1.

§ 1.735 Statutory provisions; character of gain or loss on disposition of distributed property.

SEC. 735. *Character of gain or loss on disposition of distributed property*—(a) *Sale or exchange of certain distributed property*—(1) *Unrealized receivables.* Gain or loss on the disposition by a distributee partner of unrealized receivables (as defined in section 751 (c)) distributed by a partnership, shall be considered gain or loss from the sale or exchange of property other than a capital asset.

(2) *Inventory items.* Gain or loss on the sale or exchange by a distributee partner of inventory items (as defined in section 751 (d) (2)) distributed by a partnership shall, if sold or exchanged within 5 years from the date of the distribution, be considered gain or loss from the sale or exchange of property other than a capital asset.

(b) *Holding period for distributed property.* In determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of subsection (a) (2)), there shall be included the holding period of the partnership, as determined under section 1223, with respect to such property.

§ 1.735–1 Character of gain or loss on disposition of distributed property.

(a) *Sale or exchange of distributed property*—(1) *Unrealized receivables.* Any gain realized or loss sustained by a partner on a sale or exchange or other disposition of unrealized receivables (as defined in section 751 (c)) received by him in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset.

(2) *Inventory items.* Any gain realized or loss sustained by a partner on a sale or exchange of inventory items (as defined in section 751 (d) (2)) received in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset if such inventory items are sold or exchanged within 5 years from the date of the distribution by the partnership. The character of any gain or loss from a sale or exchange by the distributee partner of such inventory items after 5 years from the date of distribution shall be determined as of the date of such sale or exchange by reference to the character of the assets in his hands at that date (inventory items, capital assets, property used in a trade or business, etc.).

(b) *Holding period for distributed property.* A partner's holding period for property distributed to him by a partnership shall include the period such property was held by the partnership. The provisions of this paragraph do not apply for the purpose of determining the 5-year period described in section 735 (a) (2) and paragraph (a) (2) of this section. If the property has been contributed to the partnership by a partner, then the period that the property was held by such partner shall also be included. See section 1223 (2). For a partnership's holding period for contributed property, see § 1.723–1.

(c) *Effective date.* Section 735 (a) applies to any property distributed by a partnership to a partner after March 9, 1954. See section 771 (b) (2) and paragraph (b) (2) of § 1.771–1. However, see section 771 (c).

§ 1.736 Statutory provisions; payments to a retiring partner or a deceased partner's successor in interest.

SEC. 736. *Payments to a retiring partner or a deceased partner's successor in interest*—(a) *Payments considered as distributive share or guaranteed payment.* Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—

(1) As a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or

(2) As a guaranteed payment described in section 707 (c) if the amount thereof is determined without regard to the income of the partnership.

(b) *Payments for interest in partnership*—(1) *General rule.* Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations prescribed by the Secretary or his delegate, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).

(2) *Special rules.* For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for—

(A) Unrealized receivables of the partnership (as defined in section 751 (c)), or

(B) Good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

§ 1.736–1 Payments to a retiring partner or a deceased partner's successor in interest.

(a) *Payments considered as distributive share or guaranteed payment.* (1) (i) Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. See section 761(d). Section 736 and this section do not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

(ii) A partner retires when he ceases to be a partner under local law. However, for the purposes of subchapter K, chapter 1 of the Code, a retired partner or a deceased partner's successor will be treated as a partner until his interest in the partnership has been completely liquidated.

(2) When payments (including assumption of liabilities treated as a distribution of money under section 752) are made to a withdrawing partner, that is, a retiring partner or the estate or other successor in interest of a deceased partner, the amounts paid may represent several items. In part, they may represent the fair market value at the time of his death or retirement of the withdrawing partner's interest in all the assets of the partnership (including inventory) unreduced by partnership liabilities. Also, part of such payments may be attributable to his interest in unrealized receivables and part to an arrangement among the partners in the nature of mutual insurance. When a partnership makes such payments, whether or not related to partnership income, to retire the withdrawing partner's entire interest in the partnership, the payments must be allocated between (i) payments for the value of his interest in assets, except unrealized receivables and, under some circumstances, good will (section 736 (b)), and (ii) other payments (section 736 (a)). The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under sections 731, 732, and, where applicable, 751. See paragraph (b) (4) (ii) of § 1.751–1. The remaining partners are allowed no deduction for these payments since they represent either a distribution or a purchase of the withdrawing partner's capital interest by the partnership (composed of the remaining partners).

(3) Under section 736 (a), the portion of the payments made to a withdrawing partner for his share of unrealized receivables, good will (in the absence of an agreement to the contrary), or otherwise not in exchange for his interest in assets under the rules contained in paragraph (b) of this section will be considered either—

(i) A distributive share of partnership income, if the amount of payment is determined with regard to income of the partnership; or

(ii) A guaranteed payment under section 707 (c), if the amount of the payment is determined without regard to income of the partnership.

(4) Payments, to the extent considered as a distributive share of partnership income under section 736 (a) (1), are taken into account under section 702 in the income of the withdrawing partner and thus reduce the amount of the distributive shares of the remaining partners. Payments, to the extent considered as guaranteed payments under section 736 (a) (2), are deductible by the partnership under section 162 (a) and are taxable as ordinary income to the recipient under section 61 (a). See section 707 (c).

(5) The amount of any payments under section 736 (a) shall be included in the income of the recipient for his taxable year with or within which ends the partnership taxable year for which the payment is a distributive share, or in which the partnership is entitled to deduct such amount as a guaranteed payment. On the other hand, payments under section 736 (b) shall be taken into account by the recipient for his taxable year in which such payments are made. See paragraph (b) (4) of this section.

(6) A retiring partner or a deceased partner's successor in interest receiving payments under section 736 is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time. Similarly, if a partner in a 2-man partnership dies, and his estate or other successor in interest receives payments under section 736, the partnership shall not be considered to have terminated upon the death of the partner but shall terminate as to both partners only when the entire interest of the decedent is liquidated. See section 708 (b).

(b) *Payments for interest in partnership.* (1) Payments made in liquidation of the entire interest of a retiring partner or deceased partner shall, to the extent made in exchange for such partner's interest in partnership property (except for unrealized receivables and good will as provided in subparagraphs (2) and (3) of this paragraph), be considered as a distribution by the partnership (and not as a distributive share or guaranteed payment under section 736 (a)). Generally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct. If such valuation reflects only the partner's net interest in the property (i. e., total assets less liabilities), it must be adjusted so that both the value of the partner's interest in property and the basis for his interest take into account the partner's share of partnership liabilities. Gain or loss with respect to distributions under section 736 (b) and this paragraph will be recognized to the distributee to the extent provided in section 731 and, where applicable, section 751.

(2) Payments made to a retiring partner or to the successor in interest of a deceased partner for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, shall not be considered as made in exchange for such partner's interest in partnership property. Such payments shall be treated as payments under section 736 (a) and paragraph (a) of this section. For definition of unrealized receivables, see section 751 (c).

(3) For the purposes of section 736 (b) and this paragraph, payments made to a retiring partner or to a successor in interest of a deceased partner in exchange for the interest of such partner in partnership property shall not include any amount paid for the partner's share of good will of the partnership in excess of its partnership basis, including any special basis adjustments for it to which such partner is entitled, except to the extent that the partnership agreement provides for a reasonable payment with respect to such good will. Such payments shall be considered as payments under section 736 (a). To the extent that the partnership agreement provides for a reasonable payment with respect to good will, such payments shall be treated under section 736 (b) and this paragraph. Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct.

(4) Payments made to a retiring partner or to a successor in interest of a deceased partner for his interest in inventory shall be considered as made in exchange for such partner's interest in partnership property for the purposes of section 736 (b) and this paragraph. However, payments for an interest in substantially appreciated inventory items, as defined in section 751 (d), are subject to the rules provided in section 751 (b) and paragraph (b) of § 1.751–1. The partnership basis in inventory items as to a deceased partner's successor in interest does not change because of the death of the partner unless the partnership has elected the optional basis adjustment under section 754. But see paragraph (b) (3) (iii) of § 1.751–1.

(5) Where payments made under section 736 are received during the taxable year, the recipient must segregate that portion of each such payment which is determined to be in exchange for the partner's interest in partnership property and treated as a distribution under section 736 (b) from that portion treated as a distributive share or guaranteed payment under section 736 (a). Such allocation shall be made as follows—

(i) If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the portion of each payment to be treated as a distribution under section 736 (b) for the taxable year shall bear the same ratio to the total fixed agreed payments for such year (as distinguished from the amount actually received) as the total fixed agreed payments under section 736 (b) bear to the total fixed agreed payments under section 736 (a) and (b). The balance, if any, of such amount received in the same taxable year shall be treated as a distributive share or a guaranteed payment under section 736 (a) (1) or (2). However, if the total amount received in any one year is less than the amount considered as a distribution under section 736 (b) for that year, then any unapplied portion shall be added to the portion of the payments for the following year or years which are to be treated as a distribution under section 736 (b). For example, retiring partner W who is entitled to an annual payment of $6,000 for 10 years for his interest in partnership property, receives only $3,500 in 1955. In 1956, he receives $10,000. Of this amount, $8,500 ($6,000 plus $2,500 from 1955) is treated as a distribution under section 736 (b) for 1956; $1,500, as a payment under section 736 (a).

(ii) If the retiring partner or deceased partner's successor in interest receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under section 736 (b) to the extent of the value of that interest and, thereafter, as payments under section 736 (a).

(iii) In lieu of the rules provided in subdivisions (i) and (ii) of this subparagraph, the allocation of each annual payment between section 736 (a) and (b) may be made in any manner to which all the remaining partners and the withdrawing partner or his successor in interest agree, provided that the total amount allocated to property under section 736 (b) does not exceed the fair market value of such property at the date of death or retirement.

(6) Except to the extent section 751 (b) applies, the amount of any gain or loss with respect to payments under section 736 (b) for a retiring or deceased partner's interest in property for each year of payment shall be determined under section 731. However, where the total of section 736 (b) payments is a fixed sum, a retiring partner or a deceased partner's successor in interest may elect (in his tax return for the first taxable year for which he receives such payments), to report and to measure the amount of any gain or loss by the difference between—

(i) The amount treated as a distribution under section 736 (b) in that year, and

(ii) The portion of the adjusted basis of the partner for his partnership interest attributable to such distribution (i. e., the amount which bears the same proportion to the partner's total adjusted basis for his partnership interest as the amount distributed under section 736 (b) in that year bears to the total amount to be distributed under section 736 (b)).

A recipient who elects under this subparagraph shall attach a statement to his tax return for the first taxable year for which he receives such payments, indicating his election and showing the computation of the gain included in gross income.

(7) The provisions of this paragraph may be illustrated by the following examples:

Example (1) Partnership ABC is a personal service partnership and its balance sheet is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$13,000	$13,000
Unrealized receivables	0	30,000
Capital and section 1231 assets	20,000	23,000
Total	33,000	66,000

LIABILITIES AND CAPITAL

	Per books	Value
Liabilities	$3,000	$3,000
Capital:		
A	10,000	21,000
B	10,000	21,000
C	10,000	21,000
Total	33,000	66,000

Partner A retires from the partnership in accordance with an agreement whereby his share of liabilities ($1,000) is assumed. In addition he is to receive $9,000 in the year of retirement plus $10,000 in each of the two succeeding years. Thus, the total that A receives for his partnership interest is $30,000 ($29,000 in cash and $1,000 in liabilities assumed). Under the agreement terminating A's interest, the value of A's interest in section 736 (b) partnership property is $12,000 (one-third of $36,000, the sum of $13,000 cash and $23,000, the fair market value of capital and section 1231 assets). A's share in unrealized receivables is not included in his interest in partnership property described in section 736 (b). Since the basis of A's interest is $11,000 ($10,000 plus $1,000, his share of partnership liabilities), he will realize a capital gain of $1,000 ($12,000 minus $11,000) from the disposition of his interest in partnership property. The remaining $18,000 ($30,000 minus $12,000) will constitute payments under section 736 (a) (2) which are taxable to A as guaranteed payments under section 707 (c). The payment for the first year is $10,000, consisting of $9,000 in cash, plus $1,000 in liability assumed (section 752 (b)). Thus, unless the partners agree otherwise under subparagraph (5) (iii) of this paragraph, each annual payment of $10,000 will be allocated as follows: $6,000 (18,000/30,000 of $10,000) is a section 736 (a) (2) payment and $4,000 (12,000/30,000 of $10,000) is a payment for an interest in section 736 (b) partnership property. (The partnership may deduct the $6,000 guaranteed payment made to A in each of the 3 years.) The gain on the payments for partnership property will be determined under section 731, as provided in subparagraph (6) of this paragraph. A will treat only $4,000 of each payment as a distribution in a series in liquidation of his entire interest and, under section 731, will have a capital gain of $1,000 when the last payment is made. However, if A so elects, as provided in subparagraph (6) of this paragraph, he may treat such gain as follows: Of each $4,000 payment attributable to A's interest in partnership property, $333 is capital gain (one-third of the total capital gain of $1,000), and $3,667 is a return of capital.

Example (2). Assume the same facts as in example (1) of this subparagraph except that the agreement between the partners provides for payments to A for 3 years of a percentage of annual income instead of a fixed amount. Unless the partners agree otherwise under subparagraph (5) (iii) of this paragraph, all payments received by A up to $12,000 shall be treated under section 736 (b) as payments for A's interest in partnership property. His gain of $1,000 will be taxed only after he has received his full basis under section 731. Since the payments are not fixed in amount, the election provided in subparagraph (6) of this paragraph is not available. Any payments in excess of $12,000 shall be treated as a distributive share of partnership income to A under section 736 (a) (1).

Example (3). Assume the same facts as in example (1) of this subparagraph except that the partnership agreement provides that the payment for A's interest in partnership property shall include payment for his interest in the good will of the partnership. At the time of A's retirement, the partners determine the value of partnership good will to

be $9,000. The value of A's interest in partnership property described in section 736 (b) is thus $15,000 (one-third of $45,000, the sum of $13,000 cash, plus $23,000, the value of capital and section 1231 assets, plus $9,000 good will). From the disposition of his interest in partnership property, A will realize a capital gain of $4,000 ($15,000, minus $11,000) the basis of his interest. The remaining $15,000 ($30,000 minus $15,000) will constitute payments under section 736 (a) (2) which are taxable to A as guaranteed payments under section 707 (c).

(c) *Cross reference.* See section 753 for treatment of payments under section 736 (a) as income in respect of a decedent under section 691.

TRANSFERS OF INTERESTS IN A PARTNERSHIP

§ 1.741 Statutory provisions; recognition and character of gain or loss on sale or exchange.

SEC. 741. *Recognition and character of gain or loss on sale or exchange.* In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).

§ 1.741–1 Recognition and character of gain or loss on sale or exchange.

(a) The sale or exchange of an interest in a partnership shall, except to the extent section 751(a) applies, be treated as the sale or exchange of a capital asset, resulting in capital gain or loss measured by the difference between the amount realized and the adjusted basis of the partnership interest, as determined under section 705. For treatment of selling partner's distributive share up to date of sale, see section 706(c)(2). Where the provisions of section 751 require the recognition of ordinary income or loss with respect to a portion of the amount realized from such sale or exchange, the amount realized shall be reduced by the amount attributable under section 751 to unrealized receivables and substantially appreciated inventory items, and the adjusted basis of the transferor partner's interest in the partnership shall be reduced by the portion of such basis attributable to such unrealized receivables and substantially appreciated inventory items. See section 751 and § 1.751–1.

(b) Section 741 shall apply whether the partnership interest is sold to one or more members of the partnership or to one or more persons who are not members of the partnership. Section 741 shall also apply even though the sale of the partnership interest results in a termination of the partnership under section 708 (b). Thus, the provisions of section 741 shall be applicable (1) to the transferor partner in a 2-man partnership when he sells his interest to the other partner, and (2) to all the members of a partnership when they sell their interests to one or more persons outside the partnership.

(c) See section 351 for nonrecognition of gain or loss upon transfer of a partnership interest to a corporation controlled by the transferor.

§ 1.742 Statutory provisions; basis of transferee partner's interest.

SEC. 742. *Basis of transferee partner's interest.* The basis of an interest in a partnership acquired other than by contribution shall be determined under part II of subchapter O (sec. 1011 and following).

§ 1.742–1 Basis of transferee partner's interest.

The basis to a transferee partner of an interest in a partnership shall be determined under the general basis rules for property provided by part II (section 1011 and following), subchapter O, chapter 1 of the Code. Thus, the basis of a purchased interest will be its cost. The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c) (3) (v) of § 1.706–1 and paragraph (b) of § 1.753–1) under section 691. See section 1014(c). For basis of contributing partner's interest, see section 722. The basis so determined is then subject to the adjustments provided in section 705.

§ 1.743 Statutory provisions; optional adjustment to basis of partnership property.

SEC. 743. *Optional adjustment to basis of partnership property*—(a) *General rule.* The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership.

(b) *Adjustment to basis of partnership property.* In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 754 is in effect shall—

(1) Increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or

(2) Decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

Under regulations prescribed by the Secretary or his delegate, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital and, in the case of an agreement described in section 704 (c) (2) (relating to effect of partnership agreement on contributed property), such share shall be determined by taking such agreement into account. In the case of an adjustment under this subsection to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for the transferee partner with respect to his interest in such property.

(c) *Allocation of basis.* The allocation of basis among partnership properties where subsection (b) is applicable shall be made in accordance with the rules provided in section 755.

§ 1.743–1 Optional adjustment to basis of partnership property.

(a) *General rule.* The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to the partnership. However, whether or not the election provided in section 754 is in effect, the basis of partnership property shall not be adjusted as the result of a contribution of property, including money, to the partnership.

(b) *Adjustment to basis of partnership property*—(1) *Determination of adjustment.* In the case of a transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, a partnership as to which the election under section 754 is in effect shall:

(i) Increase the adjusted basis of partnership property by the excess of the transferee's basis for his partnership interest over his share of the adjusted basis to the partnership of all partnership property, or

(ii) Decrease the adjusted basis of partnership property by the excess of the transferee partner's share of the adjusted basis of all partnership property over his basis for his partnership interest.

The amount of the increase or decrease constitutes an adjustment affecting the basis of partnership property with respect to the transferee partner only. Thus, for purposes of depreciation, depletion, gain or loss, and distributions, the transferee partner will have a special basis for those partnership properties which are adjusted under section 743 (b) and this paragraph. This special basis is his share of the common partnership basis (i. e., the adjusted basis of such properties to the partnership without regard to any special basis adjustments of any transferee) plus or minus his special basis adjustments. A partner's share of the adjusted basis of partnership property is equal to the sum of his interest as a partner in partnership capital and surplus, plus his share of partnership liabilities. Where an agreement with respect to contributed property is in effect under section 704 (c) (2), such agreement shall be taken into account in determining a partner's share of the adjusted basis of partnership property. Generally, if a partner's interest in partnership capital and profits is one-third, his share of the adjusted basis of partnership property will be one-third of such basis. The provisions of this paragraph may be illustrated by the following examples:

Example (1). A is a member of partnership ABC in which the partners have equal interests in capital and profits. The partnership has made the election under section 754, relating to the optional adjustment to the basis of partnership property. A sells his interest to P for $22,000. The

balance sheet of the partnership at the date of sale shows the following:

ASSETS

	Adjusted basis per books	Market value
Cash	$5,000	$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Depreciable assets	20,000	40,000
Total	55,000	76,000

LIABILITIES AND CAPITAL

	Adjusted basis per books	Value
Liabilities	$10,000	$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	55,000	76,000

The amount of the adjustment under section 743 (b) is the difference between the basis of the transferee's interest in the partnership and his share of the adjusted basis of partnership property. Under section 742, the basis of P's interest is $25,333 (the cash paid for A's interest, $22,000, plus $3,333, P's share of partnership liabilities). P's share of the adjusted basis of partnership property is $18,333, i. e., $15,000 plus $3,333. The amount to be added to the basis of partnership property is, therefore, $7,000, the difference between $25,333 and $18,333. This amount will be allocated to partnership properties in accordance with the rules set forth in section 755 and § 1.755–1.

Example (2). D is a member of partnership DEF in which the partners have equal interests in profits, but not in capital. The partnership has made the election under section 754. D dies and his interest passes to W, his widow. The balance sheet of the partnership at the date of D's death shows the following:

ASSETS

	Adjusted basis per books	Market value
Cash	$7,000	$7,000
Accounts receivable	10,000	10,000
Inventory	20,000	24,000
Depreciable assets	20,000	40,000
Total	57,000	81,000

LIABILITIES AND CAPITAL

	Adjusted basis per books	Value
Liabilities	$10,000	$10,000
Capital:		
D	18,000	26,000
E	15,000	23,000
F	14,000	22,000
Total	57,000	81,000

The amount of the adjustment under section 743 (b) is the difference between the basis of the transferee's interest in the partnership and her share of the adjusted basis of partnership property. Under section 742, the basis of W's interest is $29,333 (the fair market value of D's interest at his death, $26,000, plus $3,333, his share of partnership liabilities). W's share of the adjusted basis of partnership property is $21,333 (i. e., $18,000 plus $3,333, her share of partnership liabilities). The amount to be added to the basis of partnership property is, therefore, $8,000, the difference between $29,333 and $21,333. This amount will be allocated to partnership properties in accordance with the rules set forth in section 755 and § 1.755–1.

Note that in examples (1) and (2) of this subparagraph the amount of the adjustment does not depend upon the adjusted basis to the transferor for his interest in partnership capital.

(2) *Determination of partner's share of adjusted basis of partnership property.* (i) Under the provisions of section 743 (b), a partner's share of the adjusted basis of partnership property shall be determined by taking into account the effect of any partnership agreement with respect to contributed property as described in section 704 (c) (2), or the effect of the contribution of undivided interests under section 704 (c) (3). This rule may be illustrated by the following examples:

Example (1). A, B, and C form partnership ABC, to which A contributes land worth $1,000 (property X) with an adjusted basis to him of $400, and B and C each contributes $1,000 cash. Each partner has $1,000 credited to him on the books of the partnership as his capital contribution. The partners share in profits equally. During the partnership's first taxable year, property X appreciates in value to $1,300. A sells his one-third interest in the partnership to D for $1,100, when the election under section 754 is in effect. No agreement under section 704 (c) (2) is in effect. The adjusted basis of the partnership property is increased with respect to D by the excess of his basis for his partnership interest, $1,100, over his share of the adjusted basis of partnership property, $800 (⅓ of $2,400, the total adjusted basis of partnership property). The amount of the adjustment, therefore, is $300 ($1,100 minus $800), which is an increase in the basis of partnership property with respect to D only. This special basis adjustment will be allocated to property X. (See section 755 and § 1.755–1.) If property X is sold for $1,600, the gain to the partnership is $1,200 ($1,600 received, less the adjusted common partnership basis of $400 for property X). Thus, each partner's distributive share of the gain on the sale is $400. However, D's recognized gain is only $100 (his $400 distributive share of the gain, reduced by $300, his special basis adjustment with respect to property X). If D purchased his interest from B or C, the partners who contributed cash, D's adjustment under section 743 (b) would also be $300, computed in exactly the same manner as in the case of a purchase from A.

Example (2). Assume that partnership ABC described in example (1) of this subdivision has an agreement under section 704 (c) (2) with respect to property X, stating that upon the sale of that property any gain, to the extent attributable to the precontribution appreciation of $600 (the difference between its value, $1,000, and its basis, $400, at the time of the contribution) is to be allocated entirely to A, who contributed property X. Upon the purchase of A's interest by D for $1,100, the computation of D's special basis would differ from that indicated in example (1) of this subdivision as follows: Under the partnership agreement, A's share of the $2,400 adjusted basis of partnership property is only $400 (his basis for property X prior to its contribution to the partnership), and B's and C's share is $1,000 each (the amount of the cash investment of each). The amount of the increase to D in the adjusted basis of partnership property under section 743 (b) (1) is $700 (the excess of $1,100, D's cost basis for his interest, over $400, A's share of the adjusted basis of partnership property to which D succeeds). This amount constitutes an adjustment to the basis of partnership property with respect to D only. If X is sold by the partnership for $1,600, the gain is $1,200 ($1,600 received less the adjusted common partnership basis of $400). Under the partnership agreement, $600 of this gain, which is attributable to precontribution appreciation in value, is allocable to D, who is A's successor. The remaining $600 gain is not subject to the agreement and is allocable to the partners equally, $200 each. D's distributive share of the partnership gain is thus $600 plus $200, or $800. However, D has a special basis adjustment of $700 under section 743 (b) (1), which reduces his gain from $800 to $100. B and C each has a gain of $200, which is unaffected by the transfer of A's interest to D.

Example (3). Assume the same facts as in example (2) of this subdivision, except that D has purchased his interest from B instead of from A. His special basis adjustment for partnership property in this case differs from that where he had purchased his interest from A, because of the effect of the agreement under section 704 (c) (2). In this case, D is a successor to B, whose share of the adjusted basis of partnership property is $1,000, instead of A, whose share is only $400. As a result, the adjustment under section 743 (b) (1) is the excess of D's cost basis for his interest, $1,100, over his share of the adjusted basis of partnership property, $1,000, or $100. In this case, if property X is sold for $1,600, the partnership gain is $1,200 ($1,600 less the adjusted partnership basis of $400). Of this gain, $600, representing precontribution appreciation, is allocable to A under the partnership agreement. The remaining $600 is allocable in the amount of $200 to each partner. Since D as a transferee has a special basis adjustment of $100 under section 743 (b) (1), his gain is reduced from $200 to $100.

(ii) If a partner receives a distribution of property with respect to which another partner has a special basis adjustment, the distributee shall not take into account the special basis adjustment of the other partner. However, the partner with the special basis adjustment will reallocate it under section 755 to remaining partnership property of a like kind or, if he receives a distribution of like property, to such distributed property. If a partner receives a distribution of property with respect to which he has a special basis adjustment, such basis adjustment will be taken into account when relevant under section 732. See paragraph (b) of § 1.732–2. If, at the time a partner receives property (whether or not he has a special basis adjustment with respect to such property), he relinquishes his interest in other property of a like kind with respect to which he has a special basis adjustment, the adjusted basis to the partnership of the distributed property shall include his special basis adjustment for the property in which he relinquished his interest. For the purposes of the preceding sentence, a partner will be considered as having relinquished his interest in any remaining partnership properties when his interest has been completely liquidated; however,

when a partner receives a distribution not in liquidation, he will be considered as relinquishing his interest only in property distributed to other partners. For the purposes of this subdivision, like property means property of the same class, that is, stock in trade, property used in the trade or business, capital assets, etc. For certain adjustments to the basis of remaining partnership property after a distribution to a transferee partner, see paragraph (b) of § 1.734–2. The provisions of this subdivision may be illustrated by the following examples:

Example (1). C is a transferee partner in partnership BC. The partnership owns, among other assets, X, a depreciable asset with a common basis to the partnership of $1,000 and a special basis adjustment to C of $200, and Y, another depreciable asset with a common basis of $800 and a special basis adjustment to C of $300. B and C agree that B will receive a distribution of property Y, and C will receive a distribution of property X, with all other property to remain in the partnership. With respect to B, the partnership basis of property Y is $800, the common partnership basis. Y will, therefore, have a basis of $800 in B's hands under section 732 (a) which provides for the use of a carryover basis in the case of current distributions. With respect to C, however, the partnership basis of property X is $1,500, the common partnership basis of $1,000, plus C's special basis adjustment of $200 for property X, plus C's additional special basis adjustment of $300 for property Y, in which he has relinquished his interest.

Example (2). (a) Partner D acquired his one-third interest in partnership BCD for $14,000 from a previous partner when an election under section 754 was in effect. Therefore, under section 743 (b), D has a special basis adjustment for certain partnership property. Assume that at the time of the distribution in paragraph (b) of this example, the partnership assets consist of cash and rental property and that such assets and D's special basis adjustments under section 743 (b) are as follows:

Item	Fair market value	Common partnership basis	D's share	D's special basis adjustment	Partnership basis to D
Cash	$12,000	$12,000	$4,000	----------	$4,000
House:					
U	9,000	1,200	400	----------	400
V	6,000	4,500	1,500	----------	1,500
W	8,000	1,500	500	----------	500
X	9,000	4,800	1,600	$2,000	3,600
Y	9,000	6,000	2,000	----------	2,000
Z	7,000	3,000	1,000	1,000	2,000
Total	60,000	33,000	11,000	3,000	14,000

(b) Assume further that D receives $4,000 in cash and houses Y and Z in complete liquidation of his interest in partnership BCD. In determining the basis to D of houses Y and Z under section 732 (b) and (c), D must allocate $10,000 basis ($14,000 basis for his interest, less $4,000 cash received) to houses Y and Z in proportion to their adjusted bases to the partnership. For purposes of section 732 (c), the adjusted basis of house Y is $7,200. ($6,000 common partnership basis, plus $1,200, allocated share of D's special basis adjustment of $2,000 for house X, in which D relinquished his interest). The adjusted basis of house Z is $4,800 ($3,000 common partnership basis, plus $1,000, D's special basis for house Z, plus $800, allocated share of D's special basis of $2,000 for house X, in which D relinquished his interest). Under the rule of this subdivision, 6,000/10,000 of the $2,000 special basis adjustment for X is allocated to Y and 4,000/10,000 of such amount to Z. Therefore, $6,000 basis (7,200/12,000 of $10,000) is allocated to house Y and $4,000 basis (4,800/12,000 of $10,000) to house Z.

(c) Since houses Y and Z had $12,000 basis to the partnership, as computed in paragraph (b) of this example, and only $10,000 basis to D, as determined under section 732, the partnership, under section 734 (b) (1) (B), must increase the basis of remaining partnership property (houses U, V, W, and X) by $2,000 (excess of $12,000 over $10,000). For allocation of this amount, see section 755 and § 1.755–1.

(iii) Where an adjustment is made under section 743 (b) to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for each partner, including the transferee partner, based on his interest in such property. See paragraph (a) (8) of § 1.702–1. This rule may be illustrated by the following example:

Example. A, B, and C each contributes $5,000 cash to form partnership ABC, which purchases oil property for $15,000. C subsequently sells his partnership interest to D for $100,000 when the election under section 754 is in effect. D has a special basis adjustment for the oil property of $95,000 (the difference between D's basis, $100,000, and his share of the basis of partnership property, $5,000). Assume that the depletion allowance computed under the percentage method would be $21,000 for the taxable year so that each partner would be entitled to $7,000 as his share of the deduction for depletion. However, under the cost depletion method, at an assumed rate of 10 percent, the allowance with respect to D's one-third interest which has a basis to him of $100,000 ($5,000, plus his special basis adjustment of $95,000) is $10,000, although the cost depletion allowance with respect to the one-third interest of A and B in the oil property, each of which has a basis of $5,000, is only $500. For partners A and B, the percentage depletion is greater than cost depletion and each will deduct $7,000 based on the percentage depletion method. However, as to D, the transferee partner, the cost depletion method results in a greater allowance and D will, therefore, deduct $10,000 based on cost depletion. See section 613 (a).

(iv) Where there has been more than one transfer of partnership interests, the last transferee's special basis adjustment, if any, under section 743 (b) shall be determined by reference to the partnership common basis for its property without regard to any prior transferee's special basis adjustment. For example, A, B, and C form a partnership. A and B each contributes $1,000 cash and C contributes land with a basis and value of $1,000. When the land has appreciated in value to $1,300, A sells his interest to D for $1,100 (⅓ of $3,300, the value of the partnership property). The election under section 754 is in effect; therefore, D has a special basis adjustment of $100 with respect to the land under section 743 (b). After the land has further appreciated in value to $1,600, D sells his interest to E for $1,200 (⅓ of $3,600, the value of the partnership property). Under section 743 (b), E has a special basis adjustment of $200. This amount is determined without regard to any special basis adjustment that D may have had in the partnership assets.

(3) *Returns.* A transferee partner who has a special basis adjustment under section 743 (b) shall attach a statement to his income tax return for the first taxable year in which the basis of any partnership property subject to the adjustment is pertinent in determining his income tax, showing the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

(c) *Allocation of basis.* For the allocation of basis among partnership properties where section 743 (b) applies, see section 755 and § 1.755–1.

PROVISIONS COMMON TO PART II, SUBCHAPTER K, CHAPTER 1 OF THE CODE

§ 1.751 Statutory provisions; unrealized receivables and inventory items.

SEC. 751. *Unrealized receivables and inventory items*—(a) *Sale or exchange of interest in partnership.* The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to—

(1) Unrealized receivables of the partnership, or

(2) Inventory items of the partnership which have appreciated substantially in value,

shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

(b) *Certain distributions treated as sales or exchanges*—(1) *General rule.* To the extent a partner receives in a distribution—

(A) Partnership property described in subsection (a) (1) or (2) in exchange for all or a part of his interest in other partnership property (including money), or

(B) Partnership property (including money) other than property described in subsection (a) (1) or (2) in exchange for all or a part of his interest in partnership property described in subsection (a) (1) or (2),

such transactions shall, under regulations prescribed by the Secretary or his delegate, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

(2) *Exceptions.* Paragraph (1) shall not apply to—

(A) A distribution of property which the distributee contributed to the partnership, or

(B) Payments, described in section 736 (a), to a retiring partner or successor in interest of a deceased partner.

(c) *Unrealized receivables.* For purposes of this subchapter, the term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for—

(1) Goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

(2) Services rendered, or to be rendered.

(d) *Inventory items which have appreciated substantially in value*—(1) *Substantial appreciation.* Inventory items of the partnership shall be considered to have appreciated substantially in value if their fair market value exceeds—

(A) 120 percent of the adjusted basis to the partnership of such property, and

(B) 10 percent of the fair market value of all partnership property, other than money.

(2) *Inventory items.* For purposes of this subchapter the term "inventory items" means—

(A) Property of the partnership of the kind described in section 1221 (1),

(B) Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231, and

(C) Any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in subparagraph (A) or (B).

§ 1.751–1 Unrealized receivables and inventory items.

(a) *Sale or exchange of interest in a partnership*—(1) *Character of amount realized.* To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under section 741. For definition of "unrealized receivables" and "inventory items which have appreciated substantially in value", see section 751 (c) and (d). Unrealized receivables and substantially appreciated inventory items are hereafter in this section referred to as "section 751 property". See paragraph (e) of this section.

(2) *Determination of gain or loss.* The income or loss realized by a partner upon the sale or exchange of his interest in section 751 property is the difference between (i) the portion of the total amount realized for the partnership interest allocated to section 751 property, and (ii) the portion of the selling partner's basis for his entire interest allocated to such property. Generally, the portion of the total amount realized which the seller and the purchaser allocate to section 751 property in an arm's length agreement will be regarded as correct. The portion of the partner's adjusted basis for his partnership interest to be allocated to section 751 property shall be an amount equal to the basis such property would have had under section 732 (including subsection (d) thereof) if the selling partner had received his share of such properties in a current distribution made immediately before the sale. See §§ 1.732–1 and 1.732–2. Such basis shall reflect the rules of section 704 (c) (3), if applicable, or any agreement under section 704 (c) (2). Any gain or loss recognized which is attributable to section 751 property will be ordinary gain or loss. The difference between the remainder, if any, of the partner's adjusted basis for his partnership interest and the balance, if any, of the amount realized is the transferor's capital gain or loss on the sale of his partnership interest.

(3) *Statement required.* A transferor partner selling or exchanging any part of his interest in a partnership which has any section 751 property at the time of sale or exchange shall submit with his income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information:

(i) The date of the sale or exchange, the amount of the transferor partner's adjusted basis for his partnership interest, and the portion thereof attributable to section 751 property under section 732; and

(ii) The amount of any money and the fair market value of any other property received or to be received for the transferred interest in the partnership, and the portion thereof attributable to section 751 property.

(iii) If the transferor partner computes his adjusted basis for section 751 property under the provisions of section 732 (d), he must also include in the statement the information required by paragraph (d) (3) of § 1.732–1.

(iv) If the transferor partner has a special basis adjustment under section 743 (b), he must also include in the statement the computation of his special basis adjustment and the partnership properties to which the adjustment has been allocated.

(b) *Certain distributions treated as sales or exchanges*—(1) *In general.* (i) Certain distributions to which section 751 (b) applies are treated in part as sales or exchanges of property between the partnership and the distributee partner, and not as distributions to which sections 731 through 736 apply. A distribution treated as a sale or exchange under section 751 (b) is not subject to the provisions of section 707 (b). Section 751 (b) applies whether or not the distribution is in liquidation of the distributee partner's entire interest in the partnership. However, section 751 (b) applies only to the extent that a partner either receives section 751 property in exchange for his relinquishing any part of his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in section 751 property.

(ii) Section 751 (b) does not apply to a distribution to a partner which is not in exchange for his interest in other partnership property. Thus, section 751 (b) does not apply to the extent that a distribution consists of the distributee partner's share of section 751 property or his share of other property. Similarly, section 751 (b) does not apply to current drawings or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital. In determining whether a partner has received only his share of either section 751 property or of other property, his interest in such property remaining in the partnership immediately after a distribution must be taken into account. For example, the section 751 property in partnership ABC has a fair market value of $100,000 in which partner A has an interest of 30 percent, or $30,000. If A receives $20,000 of section 751 property in a distribution, and continues to have a 30-percent interest in the $80,000 of section 751 property remaining in the partnership after the distribution, only $6,000 ($30,000 minus $24,000 (30 percent of $80,000)) of the section 751 property received by him will be considered to be his share of such property. The remaining $14,000 ($20,000 minus $6,000) received is in excess of his share.

(iii) If a distribution is, in part, a distribution of the distributee partner's share of section 751 property, or of other property (including money) and, in part, a distribution in exchange of such properties, the distribution shall be divided for the purpose of applying section 751 (b). The rules of section 751 (b) shall first apply to the part of the distribution treated as a sale or exchange of such properties, and then the rules of sections 731 through 736 shall apply to the part of the distribution not treated as a sale or exchange. See paragraph (b) (4) (ii) of this section for treatment of payments under section 736 (a).

(2) *Distribution of section 751 property (unrealized receivables or substantially appreciated inventory items).* (i) To the extent that a partner receives section 751 property in a distribution in exchange for any part of his interest in partnership property (including money) other than section 751 property, the transaction shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the income or loss to the partnership will be measured by the difference between the adjusted basis to the partnership of the section 751 property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in other partnership property which he relinquished in the exchange. In computing the partners' distributive shares of such ordinary income or loss, the income or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702 (a) (8).

(iii) At the time of the distribution, the distributee partner realizes gain or loss measured by the difference between his adjusted basis for the property relinquished in the exchange (including any special basis adjustment which he may have) and the fair market value of the section 751 property received by him in exchange for his interest in other property which he has relinquished. The distributee's adjusted basis for the property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751 (b). The character of the gain or loss to the distributee partner shall be determined by the character of the property in which he relinquished his interest.

(3) *Distribution of partnership property other than section 751 property.* (i) To the extent that a partner receives a distribution of partnership property (including money) other than section 751 property in exchange for

any part of his interest in section 751 property of the partnership, the distribution shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes gain or loss on the sale or exchange of the property other than section 751 property. The amount of the gain to the partnership will be measured by the difference between the adjusted basis to the partnership of the distributed property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in section 751 property which he relinquished in the exchange. The character of the gain or loss to the partnership is determined by the character of the distributed property treated as sold or exchanged by the partnership. In computing the partners' distributive shares of such gain or loss, the gain or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702 (a) (8).

(iii) At the time of the distribution, the distributee partner realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the distributee partner's income or loss shall be measured by the difference between his adjusted basis for the section 751 property relinquished in the exchange (including any special basis adjustment which he may have), and the fair market value of other property (including money) received by him in exchange for his interest in the section 751 property which he has relinquished. The distributee partner's adjusted basis for the section 751 property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751 (b).

(4) *Exceptions.* (i) Section 751 (b) does not apply to the distribution to a partner of property which the distributee partner contributed to the partnership. The distribution of such property is governed by the rules set forth in sections 731 through 736, relating to distributions by a partnership.

(ii) Section 751 (b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736 (a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736 (a) and, therefore, are not subject to section 751 (b). However, payments under section 736 (b) which are considered as made in exchange for an interest in partnership property are subject to section 751 (b) to the extent that they involve an exchange of substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736 must first be divided between payments under section 736 (a) and section 736 (b). The section 736 (b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751 (b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1) (iii) of this paragraph, and section 736 and § 1.736–1.

(5) *Statement required.* A partnership which distributes section 751 property to a partner in exchange for his interest in other partnership property, or which distributes other property in exchange for any part of the partner's interest in section 751 property, shall submit with its return for the year of the distribution a statement showing the computation of any income, gain, or loss to the partnership under the provisions of section 751 (b) and this paragraph. The distributee partner shall submit with his return a statement showing the computation of any income, gain, or loss to him. Such statement shall contain information similar to that required under paragraph (a) (3) of this section.

(c) *Unrealized receivables.* (1) The term "unrealized receivables", as used in subchapter K, chapter 1 of the Code, means any rights (contractual or otherwise) to payment for—

(i) Goods delivered or to be delivered (to the extent that such payment would be treated as received for property other than a capital asset), or

(ii) Services rendered or to be rendered,

to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Such rights must have arisen under contracts or agreements in existence at the time of sale or distribution, although the partnership may not be able to enforce payment until a later time. For example, the term includes trade accounts receivable of a cash method taxpayer, and rights to payment for work or goods begun but incomplete at the time of the sale or distribution.

(2) The basis for such unrealized receivables shall include all costs or expenses attributable thereto paid or accrued but not previously taken into account under the partnership method of accounting.

(3) In determining the amount of the sale price attributable to unrealized receivables, or their value in a distribution treated as a sale or exchange, any arm's length agreement between the buyer and the seller, or between the partnership and the distributee partner, will generally establish the amount or value. In the absence of such an agreement, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.

(d) *Inventory items which have substantially appreciated in value*—(1) *Substantial appreciation.* Partnership inventory items shall be considered to have appreciated substantially in value if, at the time of the sale or distribution, the total fair market value of all the inventory items of the partnership exceeds 120 percent of the aggregate adjusted basis for such property in the hands of the partnership (without regard to any special basis adjustment of any partner) and, in addition, exceeds 10 percent of the fair market value of all partnership property other than money. The terms "inventory items which have appreciated substantially in value" or "substantially appreciated inventory items" refer to the aggregate of all partnership inventory items. These terms do not refer to specific partnership inventory items or to specific groups of such items. For example, any distribution of inventory items by a partnership the inventory items of which as a whole are substantially appreciated in value shall be a distribution of substantially appreciated inventory items for the purposes of section 751 (b), even though the specific inventory items distributed may not be appreciated in value. Similarly, if the aggregate of partnership inventory items are not substantially appreciated in value, a distribution of specific inventory items, the value of which is more than 120 percent of their adjusted basis, will not constitute a distribution of substantially appreciated inventory items. For the purpose of this paragraph, the "fair market value" of inventory items has the same meaning as "market" value in the regulations under section 471, relating to general rule for inventories.

(2) *Inventory items.* The term "inventory items" as used in subchapter K, chapter 1 of the Code, includes the following types of property:

(i) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the taxable year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business. See section 1221 (1).

(ii) Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231. Thus, accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items (see section 1221 (4)), as do any unrealized receivables.

(iii) Any other property retained by the partnership which, if held by the partner selling his partnership interest or receiving a distribution described in section 751 (b), would be considered property described in subdivisions (i) or (ii) of this subparagraph. Property actually distributed to the partner does not come within the provisions of section 751 (d) (2) (C) and this subdivision.

(e) *Section 751 property and other property.* For the purposes of this section, "section 751 property" means unrealized receivables or substantially appreciated inventory items, and "other property" means all property (including money) except section 751 property.

(f) *Effective date.* Section 751 applies to gain or loss to a seller, distributee, or partnership in the case of a sale, exchange, or distribution occurring after March 9, 1954. For the purpose of applying this paragraph in the case of a taxable year beginning before January 1, 1955, a partnership or a partner may elect to treat as applicable any other section of subchapter K, chapter 1 of the Code. Any such election shall be made by a statement submitted not later than the time prescribed by law for the filing of the return for such taxable year, or August 21, 1956, whichever date is later (but not later than 6 months after the time prescribed by law for the filing of the return for such year). See section 771(b)(3) and paragraph (b)(3) of § 1.771–1. See also section 771(c) and paragraph (c) of § 1.771–1.

(g) *Examples.* Application of the provisions of section 751 may be illustrated by the following examples:

Example (1). C buys B's interest in personal service partnership AB for $15,000, when the balance sheet of the firm (reflecting a cash receipts and disbursements method of accounting) is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$3,000	$3,000
Loans receivable	10,000	10,000
Other assets	7,000	7,000
Unrealized receivables	0	12,000
Total	20,000	32,000

LIABILITIES AND CAPITAL

	Per books	Value
Liabilities	$2,000	$2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	20,000	32,000

Section 751 (a) applies to the sale. The total amount realized by B is $16,000, consisting of the cash received, $15,000, plus $1,000, B's share of the partnership liabilities assumed by C. See section 752. B's undivided half interest in the partnership property includes a half-interest in the partnership's unrealized receivables which are worth $12,000. Consequently, $6,000 of the $16,000 realized by B shall be considered received in exchange for B's interest in the partnership attributable to its unrealized receivables. The remaining $10,000 realized by B is in exchange for a capital asset. B's basis for his partnership interest is $10,000 ($9,000, plus $1,000, B's share of partnership liabilities). No portion of this basis is attributable to B's share of the unrealized receivables of the partnership since such property has a zero basis in the hands of the partnership; therefore, B has a basis of zero for the unrealized receivables because the partnership basis for such receivables would have carried over to him under section 732 had they been distributed to him. The difference between the zero basis and the $6,000 B realized for the unrealized receivables is ordinary income to him. The entire $10,000 of B's basis is the basis for his interest in partnership property other than unrealized receivables and is applied against the remaining $10,000 ($16,000 minus $6,000) received from the sale of his interest. Therefore, B has no capital gain or loss. (If B's basis for his interest in partnership property, other than unrealized receivables, were $9,000, he would realize capital gain of $1,000. If his basis were $11,000, he would sustain a capital loss of $1,000.)

Example (2). (a) *Facts.* Partnership ABC makes a distribution to partner C in liquidation of his entire one-third interest in the partnership. At the time of the distribution, the balance sheet of the partnership, which uses the accrual method of accounting, is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$15,000	$15,000
Accounts receivable	9,000	9,000
Inventory	21,000	30,000
Depreciable property	42,000	48,000
Land	9,000	9,000
Total	96,000	111,000

LIABILITIES AND CAPITAL

	Per books	Value
Current liabilities	$15,000	$15,000
Mortgage payable	21,000	21,000
Capital:		
A	20,000	25,000
B	20,000	25,000
C	20,000	25,000
Total	96,000	111,000

The distribution received by C consists of $10,000 cash and depreciable property with a fair market value of $15,000 and an adjusted basis to the partnership of $15,000.

(b) *Presence of section 751 property.* The partnership has no unrealized receivables, but the dual test provided in section 751 (d) (1) must be applied to determine whether the inventory items of the partnership, in the aggregate, have appreciated substantially in value. The fair market value of all partnership inventory items, $39,000 (inventory $30,000, and accounts receivable $9,000), exceeds 120 percent of the $30,000 adjusted basis of such items to the partnership. The fair market value of the inventory items, $39,000, also exceeds 10 percent of the fair market value of all partnership property other than money (10 percent of $96,000 or $9,600). Therefore, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* Since C's entire partnership interest is to be liquidated, the provisions of section 736 are applicable. No part of the payment, however, is considered as a distributive share or as a guaranteed payment under section 736 (a) because the entire payment is made for C's interest in partnership property. Therefore, the entire payment is for an interest in partnership property under section 736 (b), and, to the extent applicable, subject to the rules of section 751. In the distribution, C received his share of cash ($5,000) and $15,000 in depreciable property ($1,000 less than his $16,000 share). In addition, he received other partnership property ($5,000 cash and $12,000 liabilities assumed, treated as money distributed under section 752 (b)) in exchange for his interest in accounts receivable ($3,000), inventory ($10,000), land ($3,000), and the balance of his interest in depreciable property ($1,000). Section 751 (b) applies only to the extent of the exchange of other property for section 751 property (i. e., inventory items, which include trade accounts receivable). The section 751 property exchanged has a fair market value of $13,000 ($3,000 in accounts receivable and $10,000 in inventory). Thus, $13,000 of the total amount C received is considered as received for the sale of section 751 property.

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751 (b) sale or exchange.* C's share of the inventory items is treated as if he received them in a current distribution, and his basis for such items is $10,000 ($7,000 for inventory and $3,000 for accounts receivable) as determined under paragraph (b) (3) (iii) of this section. Then C is considered as having sold his share of inventory items to the partnership for $13,000. Thus, on the sale of his share of inventory items, C realizes $3,000 of ordinary income.

(2) *The part of the distribution not under section 751 (b).* Section 751 (b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752 (a). This basis is reduced by $10,000, the basis attributed to the section 751 property treated as distributed to C and sold by him to the partnership. Thus, C has a basis of $22,000 for the remainder of his partnership interest. The total distribution to C was $37,000 ($22,000 in cash and liabilities assumed, and $15,000 in depreciable property). Since C received no more than his share of the depreciable property, none of the depreciable property constitutes proceeds of the sale under section 751 (b). C did receive more than his share of money. Therefore, the sale proceeds, treated separately in subparagraph (1) of this paragraph of this example, must consist of money and therefore must be deducted from the money distribution. Consequently, in liquidation of the balance of C's interest, he receives depreciable property and $9,000 in money ($22,000 less $13,000). Therefore, no gain or loss is recognized to C on the distribution. Under section 732 (b), C's basis for the depreciable property is $13,000 (the remaining basis of his partnership interest, $22,000, reduced by $9,000, the money received in the distribution).

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751 (b) sale or exchange.* The partnership consisting of the remaining members has no ordinary income on the distribution since it did not give up any section 751 property in the exchange. Of the $22,000 money distributed (in cash and the assumption of C's share of liabilities), $13,000 was paid to acquire C's interest in inventory ($10,000 fair market value) and in accounts receivable ($3,000). Since under section 751 (b) the partnership is treated as buying these properties, it has a new cost basis for the inventory and accounts receivable acquired from C. Its basis for C's share of inventory and accounts receivable is $13,000, the amount which the partnership is considered as having paid C in the exchange. Since the partnership is treated as having distributed C's share of inventory and accounts receivable to him, the partnership must decrease its basis for inventory and accounts receivable ($30,000) by $10,000, the basis of C's share treated as distributed to him, and then increase the basis for inventory and accounts receivable by $13,000 to reflect the purchase prices of the items acquired. Thus, the basis of the partnership inventory is increased from $21,000 to $24,000 in the transaction. (Note that the basis of property acquired in a section 751 (b) exchange is determined under section 1012 without regard to any elections of the part-

nership. See paragraph (e) of § 1.732–1.) Further, the partnership realizes no capital gain or loss on the portion of the distribution treated as a sale under section 751(b) since, to acquire C's interest in the inventory and accounts receivable, it gave up money and assumed C's share of liabilities.

(2) *The part of the distribution not under section 751 (b).* In the remainder of the distribution to C which was not in exchange for C's interest in section 751 property, C received only other property as follows: $15,000 in depreciable property (with a basis to the partnership of $15,000) and $9,000 in money ($22,000 less $13,000 treated under subparagraph (1) of this paragraph of this example). Since this part of the distribution is not an exchange of section 751 property for other property, section 751 (b) does not apply. Instead, the provisions which apply are sections 731 through 736, relating to distributions by a partnership. No gain or loss is recognized to the partnership on the distribution. (See section 731 (b).) Further, the partnership makes no adjustment to the basis of remaining depreciable property unless an election under section 754 is in effect. (See section 734 (a).) Thus, the basis of the depreciable property before the distribution, $42,000, is reduced by the basis of the depreciable property distributed, $15,000, leaving a basis for the depreciable property in the partnership of $27,000. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734 (b) as follows: Since the adjusted basis of the distributed property to the partnership had been $15,000, and is only $13,000 in C's hands (see paragraph (d) (2) of this example), the partnership will increase the basis of the depreciable property remaining in the partnership by $2,000 (the excess of the adjusted basis to the partnership of the distributed depreciable property immediately before the distribution over its basis to the distributee). Whether or not an election under section 754 is in effect, the basis for each of the remaining partner's partnership interests will be $38,000 ($20,000 original contribution, plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities each assumed).

(f) *Partnership trial balance.* A trial balance of the AB partnership after the distribution in liquidation of C's entire interest would reflect the results set forth in the schedule below. Column I shows the amounts to be reflected in the records if an election is in effect under section 754 with respect to an optional adjustment under section 734 (b) to the basis of undistributed partnership property. Column II shows the amounts to be reflected in the records where an election under section 754 is not in effect. Note that in column II, the total bases for the partnership assets do not equal the total of the bases for the partnership interests.

	I Sec. 754, Election in effect		II Sec. 754, Election not in effect	
	Basis	Fair market value	Basis	Fair market value
Cash	$5,000	$5,000	$5,000	$5,000
Accounts receivable	9,000	9,000	9,000	9,000
Inventory	24,000	30,000	24,000	30,000
Depreciable property	29,000	33,000	27,000	33,000
Land	9,000	9,000	9,000	9,000
	76,000	86,000	74,000	86,000
Current liabilities	15,000	15,000	15,000	15,000
Mortgage	21,000	21,000	21,000	21,000
Capital:				
A	20,000	25,000	20,000	25,000
B	20,000	25,000	20,000	25,000
	76,000	86,000	76,000	86,000

Example (3). (a) *Facts.* Assume that the distribution to partner C in example (2) of this paragraph in liquidation of his entire interest in partnership ABC consists of $5,000 in cash and $20,000 worth of partnership inventory with a basis of $14,000.

(b) *Presence of section 751 property.* For the same reason as stated in paragraph (b) of example (2), the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* In the distribution, C received his share of cash ($5,000) and his share of appreciated inventory items ($13,000). In addition, he received appreciated inventory with a fair market value of $7,000 (and with an adjusted basis to the partnership of $4,900) and $12,000 in money (liabilities assumed). C has relinquished his interest in $16,000 of depreciable property and $3,000 of land. Although C relinquished his interest in $3,000 of accounts receivable, such accounts receivable are inventory items and, therefore, that exchange was not an exchange of section 751 property for other property. Section 751 (b) applies only to the extent of the exchange of other property for section 751 property (i. e., depreciable property or land for inventory items). Assume that the partners agree that the $7,000 of inventory in excess of C's share was received by him in exchange for $7,000 of depreciable property.

(d) *Distributee partner's tax consequences.* C's tax consequence on the distributions are as follows:

(1) *The section 751 (b) sale or exchange.* C is treated as if he had received his 7/16ths share of the depreciable property in a current distribution. His basis for that share is $6,125 (42,000/48,000 of $7,000), as determined under paragraph (b) (2) (iii) of this section. Then C is considered as having sold his 7/16ths share of depreciable property to the partnership for $7,000, realizing a gain of $875.

(2) *The part of the distribution not under section 751 (b).* Section 751 (b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000, plus $12,000, his share of partnership liabilities). See section 752 (a). This basis is reduced by $6,125, the basis of property treated as distributed to C and sold by him to the partnership. Thus, C will have a basis of $25,875 for the remainder of his partnership interest. Of the $37,000 total distribution to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751 (b). Under section 732 (b), C's basis for the inventory with a fair market value of $13,000 (which had an adjusted basis to the partnership of $9,100) is limited to $8,875, the amount of the remaining basis for his partnership interest, $25,875, reduced by $17,000, the money received. Thus, C's total aggregate basis for the inventory received is $15,875 ($7,000 plus $8,875), and not its $14,000 basis in the hands of the partnership.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751 (b) sale or exchange.* The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of the $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/16ths of C's interest in the depreciable property. Since, under section 751 (b), the partnership is treated as buying this property from C, it has a new cost basis for such property. Its basis for the depreciable property is $42,875 ($42,000 less $6,125, the basis of the 7/16ths share considered as distributed to C, plus $7,000, the partnership purchase price for this share).

(2) *The part of the distribution not under section 751 (b).* In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731 (b). Further, under section 734 (a), the partnership makes no adjustment to the basis of the accounts receivable or the 9/16ths interest in depreciable property which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734 (b) since the adjusted basis to the partnership of the inventory distributed had been $9,100, and C's basis for such inventory after distribution is only $8,875. The basis of the inventory remaining in the partnership must be increased by $225. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution, plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities now assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon that part of the distribution treated as a sale or exchange).

Example (4). (a) *Facts.* Assume the same facts as in example (3) of this paragraph, except that the partners did not identify the property which C relinqushed in exchange for the $7,000 of inventory which he received in excess of his share.

(b) *Presence of section 751 property.* For the same reasons stated in paragraph (b) of example (2) of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* The analysis stated in paragraph (c) of example (3) of this paragraph is the same in this example, except that, in the absence of a specific agreement among the partners as to the properties exchanged, C will be presumed to have sold to the partnership a proportionate amount of each property in which he relinquished an interest. Thus, in the absence of an agreement, C has received $7,000 of inventory in exchange for his release of 7/19ths of the depreciable property and 7/19ths of the land. ($7,000, fair market value of property released, over $19,000, the sum of the fair market values of C's interest in the land and C's interest in the depreciable property.)

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751 (b) sale or exchange.* C is treated as if he had received his 7/19ths shares of the depreciable property and land in a current distribution. His basis for those shares is $6,263 (51,000/57,000 of $7,000, their fair market value), as determined under paragraph (b) (2) (iii) of this section. Then C is considered as having sold his 7/19ths shares of depreciable property and land to the partnership for $7,000, realizing a gain of $737.

(2) *The part of the distribution not under section 751 (b).* Section 751 (b) does not apply to the balance of the distribution. Before the distribution C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752 (a). This basis is reduced by $6,263, the bases of C's shares of depreciable property and land treated as distributed to him and sold by him to the partnership. Thus, C will have a basis of $25,737 for the remainder of his partnership interest. Of the total $37,000 distributed to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751 (b). Under section 732 (b), C's basis for the inventory (with a fair market value of $13,000 and an adjusted basis to the partnership of $9,100) is limited to $8,737, the amount of the remaining basis

for his partnership interest ($25,737 less $17,000, money received. Thus, C's total aggregate basis for the inventory he received is $15,737 ($7,000 plus $8,737), and not the $14,000 basis it had in the hands of the partnership.

(c) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751 (b) sale or exchange.* The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/19ths of C's interest in the depreciable property and land. Since, under section 751 (b), the partnership is treated as buying this property from C, it has a new cost basis for such property. The bases of the depreciable property and land would be $42,737 and $9,000, respectively. The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $5,158 basis (42,000/48,000 of $5,895) for C's 7/19ths interest constructively distributed and increased by $5,895 (16,000/19,000 of $7,000), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $1,105 basis ($9,000/9,000 of $1,105) of land constructively distributed to C, and increased by $1,105 (3,000/19,000 of $7,000), the portion of the purchase price allocated to the land.

(2) *The part of the distribution not under section 751 (b).* In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731 (b). Further, under section 734 (a), the partnership makes no adjustment to the basis of the accounts receivable or the 12/19ths interests in depreciable property and land which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734 (b) since the adjusted basis to the partnership of the inventory distributed had been $9,100 and C's basis for such inventory after the distribution is only $8,737. The basis of the inventory remaining in the partnership must be increased by the difference of $363. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be $89,050 ($20,000 original contribution plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon the part of the distribution treated as a sale or exchange).

Example (5). (a) *Facts.* Assume that partner C in example (2) of this paragraph agrees to reduce his interest in capital and profits from one-third to one-fifth for a current distribution consisting of $5,000 in cash, and $7,500 of accounts receivable with a basis to the partnership of $7,500. At the same time, the total liabilities of the partnership are not reduced. Therefore, after the distribution, C's share of the partnership liabilities has been reduced by $4,800 from $12,000 (⅓ of $36,000) to $7,200 (⅕ of $36,000).

(b) *Presence of section 751 property.* For the same reasons as stated in paragraph (b) of example (2) of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* C's interest in the fair market value of the partnership properties before and after the distribution can be illustrated by the following table:

Item	C's interest Fair Market Value		C received		C relinquished
	One-third before	One-fifth after	Distribution of share	In excess of share	
Cash	$5,000	$2,000	$3,000	$2,000	
Liabilities assumed	(12,000)	(7,200)		4,800	
Inventory items:					
Accounts receivable	3,000	300	2,700	4,800	
Inventory	10,000	6,000			
Depreciable property	16,000	9,600			$4,000
Land	3,000	1,800			6,400
					1,200
Total	25,000	12,500	5,700	11,600	11,600

Although C relinquished his interest in $4,000 of inventory and received $4,800 of accounts receivable, both items constitute section 751 property and C has received only $800 of accounts receivable for $800 worth of depreciable property or for an $800 undivided interest in land. In the absence of an agreement identifying the properties exchanged, it is presumed C received $800 for proportionate shares of his interests in both depreciable property and land. To the extent that inventory was exchanged for accounts receivable, or to the extent cash was distributed for the release of C's interest in the balance of the depreciable property and land, the transaction does not fall within section 751 (b) and is a current distribution under section 732 (a). Thus, the remaining $6,700 of accounts receivable are received in a current distribution.

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751 (b) sale or exchange.* Assuming that the partners paid $800 worth of accounts receivable for $800 worth of depreciable property, C is treated as if he received the depreciable property in a current distribution, and his basis for the $800 worth of depreciable property is $700 (42,000/48,000 of $800, its fair market value), as determined under paragraph (b) (2) (iii) of this section. Then C is considered as having sold his $800 share of depreciable property to the partnership for $800. On the sale of the depreciable property, C realizes a gain of $100. If, on the other hand, the partners had agreed that C exchanged an $800 interest in the land for $800 worth of accounts receivable, C would realize no gain or loss, because under paragraph (b) (2) (iii) of this section his basis for the land sold would be $800. In the absence of an agreement, the basis for the depreciable property and land (which C is considered as having received in a current distribution and then sold back to the partnership) would be $716 (51,000/57,000 of $800). In that case, on the sale of the balance of the $800 share of depreciable property and land, C would realize $84 of gain ($800 less $716).

(2) *The part of the distribution not under section 751 (b).* Section 751 (b) does not apply to the balance of the distribution. Under section 731, C does not realize either gain or loss on the balance of the distribution. The adjustments to the basis of C's interest are illustrated in the following table:

	If accounts receivable received for depreciable property	If accounts receivable received for land	If there is no agreement
Original basis for C's interest	$32,000	$32,000	$32,000
Less basis of property distributed prior to sec. 751 (b) sale or exchange	−700	−800	−716
	31,300	31,200	31,284
Less money received in distribution	−9,800	−9,800	−9,800
	21,500	21,400	21,484
Less basis of property received in a current distribution under sec. 732	−6,700	−6,700	−6,700
Resulting basis for C's interest	14,800	14,700	14,784

C's basis for the $7,500 worth of accounts receivable which he received in the distribution will be $7,500, composed of $800 for the portion purchased in the section 751 (b) exchange, plus $6,700, the basis carried over under section 732 (a) for the portion received in the current distribution.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751 (b) sale or exchange.* The partnership realizes no gain or loss in the section 751 sale or exchange because it had a basis of $800 for the accounts receivable for which it received $800 worth of other property. If the partnership agreed to purchase $800 worth of depreciable property, the partnership basis of depreciable property becomes $42,100 ($42,000 less $700 basis of property constructively distributed to C, plus $800, price of property purchased). If the partnership purchased land with the accounts receivable, there would be no change in the basis of the land to the partnership because the basis of land distributed was equal to its purchase price. If there were no agreement, the basis of the depreciable property and land would be $51,084 (depreciable property, $42,084 and land $9,000). The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $590 basis (42,000/48,000 of $674) for C's $674 interest constructively distributed, and increased by $674 (6,400/7,600 of $800), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $126 basis (9,000/9,000 of $126) of the land constructively distributed to C, and increased by $126 (1,200/7,600 of $800), the portion of the purchase price allocated to the land.

(2) *The part of the distribution not under section 751 (b).* The partnership will realize no gain or loss in the balance of the distribution under section 731. Since the property in C's hands after the distribution will have the same basis it had in the partnership, the basis of partnership property remaining in the partnership after the distribution will not be adjusted (whether or not an election under 754 is in effect).

§ 1.752 Statutory provisions; treatment of certain liabilities.

SEC. 752. *Treatment of certain liabilities—*

(a) *Increase in partner's liabilities.* Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) *Decrease in partner's liabilities.* Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

(c) *Liability to which property is subject.* For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

(d) *Sale or exchange of an interest.* In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

§ 1.752–1 Treatment of certain liabilities.

(a) *Increase in partner's liabilities.* (1) Where the liabilities of a partnership are increased, and each partner's share of such liabilities is thereby increased, the amount of each partner's increase shall be treated as a contribution of money by that partner to the partnership. For example, partnership AB borrows $1,000. If A and B are equal partners, the basis of the partnership interest of each is increased by $500 since each is considered under section 752 (a) to have contributed that amount of money to the partnership.

(2) Any increase in a partner's individual liabilities because of the assumption by him of partnership liabilities shall also be considered as a contribution of money by him to the partnership. For example, equal partnership AB owns real property with an adjusted basis to the partnership of $1,000, a fair market value of $800, and which is subject to a mortgage of $400 which the partnership has not assumed. The mortgage is considered as a liability of the partnership under section 752 (c). Since A and B each share one-half thereof, under section 752 (a) the liability of each has been increased $200. Under section 722 such $200 increase is reflected in the basis of each partner for his interest. The real property is distributed by the partnership to A. Under the provisions of section 733 (2), there is a net decrease of $800 in A's basis for his partnership interest. This amount is computed as follows: The basis of A's partnership interest is decreased in the distribution by $1,000 (the partnership basis for the distributed property) and further decreased under section 752 (b) by $200 (the decrease in A's share of partnership liabilities) and increased under section 752 (a) by $400 (the increase in A's individual liability by reason of section 752 (c)). Conversely, the basis of B's partnership interest is decreased by $200 since the distribution of the real property to A resulted in a decrease in B's share of the partnership liability under section 752 (b).

(b) *Decrease in partner's liabilities.* (1) Where the liabilities of a partnership are decreased, and each partner's share of such liabilities is thereby decreased, the amount of the decrease shall be treated as a distribution of money to the partner by the partnership. For example, partnership AB, in which A and B are equal partners, repays an obligation of $10,000. The repayment reduces each partner's share of partnership liabilities by $5,000 and is considered a distribution of money which reduces the basis of each partner's interest in the partnership by that amount. For the effect of a discharge of indebtedness on the basis of partnership property, see sections 108 and 1017.

(2) Where a partnership assumes the separate liabilities of a partner or a liability to which property owned by such partner is subject (see paragraph (c) of this section), the amount of the decrease in such partner's liabilities is treated as a distribution of money by the partnership to such partner. For example, partner A contributes property with a basis of $1,000 to partnership ABC in exchange for a one-third interest in the partnership. The property is subject to a mortgage of $150. (It is immaterial whether the mortgage is assumed by the partnership. See section 752 (c).) The basis of A's partnership interest is $900, computed as follows: $1,000, A's basis for the contributed property, reduced by $100, two-thirds of A's original liability of $150 now attributable to partners B and C and reflected in their bases under the provisions of paragraph (a) of this section.

(c) *Liability to which property is subject.* Where property subject to a liability is contributed by a partner to a partnership, or distributed by a partnership to a partner, the amount of the liability, to an extent not exceeding the fair market value of the property at the time of the contribution or distribution, shall be considered as a liability assumed by the transferee. For example, A contributes property with a basis to him of $1,000 to equal partnership AB. The property is subject to a mortgage of $2,500 and its value exceeds $2,500. Under paragraph (b) of this section, A will be treated as receiving a distribution in money of $1,250, one-half of the liability of $2,500 assumed by the partnership. Since the basis of A's partnership interest is $1,000 (the basis of the property contributed by him), the distribution to him of $1,250 results in his realizing a capital gain of $250 under section 731 (a). A's basis for his partnership interest is zero. Although as a partner A has a $1,250 share of the $2,500 partnership liability, this $1,250 is not added to the basis of A's partnership interest since it does not represent an increase in liabilities as to him.

(d) *Sale or exchange of a partnership interest.* Where there is a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships. For example, if a partner sells his interest in a partnership for $750 cash and at the same time transfers to the purchaser his share of partnership liabilities amounting to $250, the amount realized by the seller on the transaction is $1,000.

(e) *Partner's share of partnership liabilities.* A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752 (c) in the same proportion as they share the profits. The provisions of this paragraph may be illustrated by the following example:

Example. G is a general partner and L is a limited partner in partnership GL. Each makes equal contributions of $20,000 cash to the partnership upon its formation. Under the terms of the partnership agreement, they are to share profits equally but L's liabilities are limited to the extent of his contribution. Subsequently, the partnership pays $10,000 for real property which is subject to a mortgage of $5,000. Neither the partnership nor any of the partners assume any liability on the mortgage. The basis of such property to the partnership is $15,000. The basis of G and L for their partnership interests is increased by $2,500 each, since each partner's share of the partnership liability (the $5,000 mortgage) has increased by that amount. However, if the partnership had assumed the mortgage so that G had become personally liable thereunder, G's basis for his interest would have been increased by $5,000 and L's basis would remain unchanged.

(f) *Limitation.* In determining the amount of liabilities for the purposes of section 752 and this section, the amount of an indebtedness is to be taken into account only once, even though a partner (in addition to his liability for such indebtedness as a partner) may be separately liable therefor in a capacity other than as a partner.

§ 1.753 Statutory provisions; partner receiving income in respect of decedent.

SEC. 753. *Partner receiving income in respect of decedent.* The amount includible in the gross income of a successor in interest of a deceased partner under section 736 (a) shall be considered income in respect of a decedent under section 691.

§ 1.753–1 Partner receiving income in respect of decedent.

(a) *Income in respect of a decedent under section 736(a).* All payments coming within the provisions of section 736(a) made by a partnership to the estate or other successor in interest of a deceased partner are considered income in respect of the decedent under section 691. The estate or other successor in interest of a deceased partner shall be considered to have received income in respect of a decedent to the extent that amounts are paid by a third person in exchange for rights to future payments from the partnership under section 736 (a). When a partner who is receiving payments under section 736(a) dies, sec-

tion 753 applies to any remaining payments under section 736 (a) made to his estate or other successor in interest.

(b) *Other income in respect of a decedent.* When a partner dies, the entire portion of the distributive share which is attributable to the period ending with the date of his death and which is taxable to his estate or other successor constitutes income in respect of a decedent under section 691. This rule applies even though that part of the distributive share for the period before death which the decedent withdrew is not included in the value of the decedent's partnership interest for estate tax purposes. See paragraph (c) (3) of § 1.706–1.

(c) *Example.* The provisions of this section may be illustrated by the following example:

Example. A and the decedent B were equal partners in a business having assets (other than money) worth $40,000 with an adjusted basis of $10,000. Certain partnership business was well advanced towards completion before B's death and, after B's death but before the end of the partnership year, payment of $10,000 was made to the partnership for such work. The partnership agreement provided that, upon the death of one of the partners, all partnership property, including unfinished work, would pass to the surviving partner, and that the surviving partner would pay the estate of the decedent the undrawn balance of his share of partnership earnings to the date of death, plus $10,000 in each of the three years after death. B's share of earnings to the date of his death was $4,000, of which he had withdrawn $3,000. B's distributive share of partnership income of $4,000 to the date of his death is income in respect of a decedent (although only the $1,000 undrawn at B's death will be reflected in the value of B's partnership interest on B's estate tax return). Assume that the value of B's interest in partnership property at the date of his death was $22,000, composed of the following items: B's one-half share of the assets of $40,000, plus $2,000, B's interest in partnership cash. It should be noted that B's $1,000 undrawn share of earnings to the date of his death is not a separate item but will be paid from partnership assets. Under the partnership agreement, A is to pay B's estate a total of $31,000. The difference of $9,000 between the amount to be paid by A ($31,000) and the value of B's interest in partnership property ($22,000) comes within section 736 (a) and, thus, also constitutes income in respect of a decedent. (However, the $17,000 difference between the $5,000 basis for B's share of the partnership property and its $22,000 value at the date of his death does not constitute income in respect of a decedent.) If, before the close of the partnership taxable year, A pays B's estate $11,000, of which they agree to allocate $8,000 as the payment under section 736 (a), B's estate will include $7,000 in its gross income (B's $4,000 distributive share plus $3,000 payment under section 736 (a)). In computing the deduction under section 691 (c), this $7,000 will be considered as the value for estate tax purposes of such income in respect of a decedent, even though only $4,000 ($1,000 of distributive share not withdrawn, plus $3,000, payment under section 736 (a)) of this amount can be identified on the estate tax return as part of the partnership interest.

(d) *Effective date.* The provisions of section 753 apply only in the case of payments made with respect to decedents whose death occurred after December 31, 1954. See section 771(b)(4) and paragraph (b)(4) of § 1.771–1.

§ 1.754 Statutory provisions; manner of electing optional adjustment to basis of partnership property.

SEC. 754. *Manner of electing optional adjustment to basis of partnership property.* If a partnership files an election, in accordance with regulations prescribed by the Secretary or his delegate, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734 and, in the case of a transfer of a partnership interest, in the manner provided in section 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent taxable years. Such election may be revoked by the partnership, subject to such limitations as may be provided by regulations prescribed by the Secretary or his delegate.

§ 1.754–1 Time and manner of making election to adjust basis of partnership property.

(a) *In general.* A partnership may adjust the basis of partnership property under sections 734(b) and 743(b) if it files an election in accordance with the rules set forth in paragraph (b) of this section. An election may not be filed to make the adjustments provided in either section 734(b) or section 743(b) alone, but such an election must apply to both sections. An election made under the provisions of this section shall apply to all property distributions and transfers of partnership interests taking place in the partnership taxable year for which the election is made and in all subsequent partnership taxable years unless the election is revoked pursuant to paragraph (c) of this section.

(b) *Method of making election.* An election under this section to adjust the basis of partnership property under sections 734 (b) and 743 (b) shall be made in a written statement filed with the partnership return for the first taxable year to which the election applies (or before August 23, 1956). The statement shall (1) set forth the name and address of the partnership making the election, (2) be signed by any one of the partners, and (3) contain a declaration that the partnership elects to apply the provisions of section 734 (b) and section 743 (b).

(c) *Revocation of election.* A partnership having an election in effect under this section may revoke such election with the approval of the district director for the internal revenue district in which the partnership return is required to be filed. A partnership which wishes to revoke such an election shall file with the district director for the internal revenue district in which the partnership return is required to be filed an application setting forth the grounds on which the revocation is desired. The application shall be filed not later than 30 days after the close of the partnership taxable year with respect to which revocation is intended to take effect and shall be signed by any one of the partners. Examples of situations which may be considered sufficient reason for approving an application for revocation include a change in the nature of the partnership business, a substantial increase in the assets of the partnership, a change in the character of partnership assets, or an increased frequency of retirements or shifts of partnership interests, so that an increased administrative burden would result to the partnership from the election. However, no application for revocation of an election shall be approved when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution.

§ 1.755 Statutory provisions; rules for allocation of basis.

SEC. 755. *Rules for allocation of basis*—(a) *General rule.* Any increase or decrease in the adjusted basis of partnership property under section 734 (b) (relating to the optional adjustment to the basis of undistributed partnership property) or section 743 (b) (relating to the optional adjustment to the basis of partnership property in the case of a transfer of an interest in a partnership) shall, except as provided in subsection (b), be allocated—

(1) In a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties, or

(2) In any other manner permitted by regulations prescribed by the Secretary or his delegate.

(b) *Special rule.* In applying the allocation rules provided in subsection (a), increases or decreases in the adjusted basis of partnership property arising from a distribution of, or a transfer of an interest attributable to, property consisting of—

(1) Capital assets and property described in section 1231 (b), or

(2) Any other property of the partnership, shall be allocated to partnership property of a like character except that the basis of any such partnership property shall not be reduced below zero. If, in the case of a distribution, the adjustment to basis of property described in paragraph (1) or (2) is prevented by the absence of such property or by insufficient adjusted basis for such property, such adjustment shall be applied to subsequently acquired property of a like character in accordance with regulations prescribed by the Secretary or his delegate.

§ 1.755–1 Rules for allocation of basis.

(a) *General rule.* (1)(i) A partnership which has elected under section 754 must adjust the basis of partnership property under the provisions of section 734 (b) (relating to the optional adjustment to the basis of undistributed partnership property) and section 743 (b) (relating to the optional adjustment to the basis of partnership property where a partnership interest is transferred). The amount of the increase or decrease (as determined in those sections) in the adjusted basis of the partnership property shall first be divided, under paragraph (b) of this section, between the two classes of property described in section 755 (b). Then, the portion of the increase or decrease allocated to each class shall be further allocated to the bases of the properties within the class in a manner which will reduce the difference between the fair market value and the adjusted basis of partnership properties. In the alternative, any increase or decrease may be allocated in any other manner approved by the district director under subparagraph (2) of this paragraph.

(ii) If there is an increase in basis to be allocated to partnership assets, such increase must be allocated only to assets whose values exceed their bases and in proportion to the difference between the value and basis of each. No increase shall be made to the basis of any asset the adjusted basis of which equals or exceeds its fair market value.

(iii) If there is a decrease in basis to be allocated to partnership assets, such decrease must be allocated to assets whose bases exceed their value and in proportion to the difference between the basis and value of each. No decrease shall be made to the basis of any asset, the fair market value of which equals or exceeds its adjusted basis.

(iv) The application of the rules with respect to the allocation of an adjustment in basis under subdivisions (ii) and (iii) of this subparagraph requires that a portion of such adjustment be allocated to partnership good will, to the extent that good will exists and is reflected in the value of the property distributed, the price at which the partnership interest is sold, or the basis of the partnership interest determined under section 1014, in accordance with the difference between such value of the good will and its adjusted basis at the time of the transaction.

(2) If a partnership (or a partner electing under section 732 (d)) desires to adjust the basis of assets under section 734 (b) or 743 (b) in a manner other than that prescribed in subparagraph (1) of this paragraph, it must file an application for permission to use such method with the district director no later than 30 days after the close of the partnership taxable year in which the proposed adjustment is to be made. The application must describe the proposed adjustments in detail and set forth the reasons for the desired use of the other method. Under section 755 (a) (2), the district director may permit the partnership to increase the bases of some partnership properties and decrease the bases of other partnership properties under section 734 (b) or 743 (b). Each increase or decrease to the basis of an asset must reduce or eliminate the difference between such basis and the value of the asset. The net amount of all such adjustments must equal the amount of the adjustment under section 734 (b) or 743 (b). Adjustments that both increase and decrease the basis of partnership assets will be permitted by the district director only upon a satisfactory showing of the values for partnership assets used by the parties to determine the price at which a partnership interest was sold, the value of the decedent's partnership interest at date of death (or at the alternate valuation date, if used), or the amount of a distribution.

(b) *Special rules.* For the purposes of applying section 755, all partnership property shall be classified into two categories: capital assets and property described in section 1231 (b) (certain property used in the trade or business), or any other property of the partnership.

(1) *Distributions.* (i) Where there is a distribution of partnership property resulting in an adjustment to the basis of undistributed partnership property under section 734 (b) (1) (B) or (b) (2) (B), such adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Thus, when the partnership adjusted basis of distributed capital assets and section 1231 (b) property immediately prior to distribution exceeds the basis of such property to the distributee partner (as determined under section 732), the basis of the undistributed capital assets and section 1231 (b) property remaining in the partnership shall be increased by an amount equal to such excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital assets and section 1231 (b) property exceeds the partnership adjusted basis of such property immediately prior to the distribution, the basis of the undistributed capital assets and section 1231 (b) property remaining in the partnership shall be decreased by an amount equal to such excess. Similarly, where there is a distribution of partnership property other than capital assets and section 1231 (b) property, and the basis of such other property to the distributee partner (as determined under section 732) is not the same as the partnership adjusted basis of such property immediately prior to distribution, the adjustment shall be made only to undistributed property of the same category remaining in the partnership.

(ii) Where there is a distribution resulting in an adjustment under section 734 (b) (1) (A) or (b) (2) (A) to the basis of undistributed partnership property, such adjustment must be allocated only to capital assets or section 1231 (b) property.

(2) *Transfers.* Where there is a basis adjustment under section 743 (b) arising from a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, the amount of the adjustment shall be allocated between the two classes of property described in section 755 (b) and then the amount allocated to each class shall be further allocated under the rules of paragraph (a) (1) of this section. Thus, to the extent that an amount paid by a purchaser of a partnership interest (or the basis of the partnership interest to the estate or other successor in interest of a deceased partner) is attributable to the value of capital assets and section 1231 (b) property, any difference between the amount so attributable and the transferee partner's share of the partnership basis of such property shall constitute a special basis adjustment with respect to partnership capital assets and section 1231 (b) property. Similarly, any such difference attributable to any other property of the partnership shall constitute a special basis adjustment with respect to such property.

(3) *Limitation on decrease of basis.* Where a decrease in the basis of partnership assets is required under section 734 (b) (2) and the amount of the decrease exceeds the adjusted basis to the partnership of property of the required character, the basis of such property shall be reduced to zero (but not below zero), and the balance of the decrease in basis shall be made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(4) *Carryover of adjustment.* Where, in the case of a distribution, an increase or decrease required under paragraph (a) of this section in the basis of undistributed partnership property cannot be made because the partnership owns no property of the character required to be adjusted, or because the adjustment has been limited under subparagraph (3) of this paragraph, the adjustment shall be made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). Assume that partnership ABC has three assets: X, a capital asset with an adjusted basis of $1,000 and a value of $1,500; Y, a depreciable asset with an adjusted basis of $1,000 and a value of $900; and Z, inventory items with an adjusted basis of $700 and a value of $600. A sells his interest to D (when an election under 754 is in effect) for $1,000 (⅓ of $3,000, the total value of partnership assets). D's share of the adjusted basis of partnership property is $900 (⅓ of $2,700). Therefore, under section 743 (b), D has a special basis adjustment of $100 ($1,000 minus $900). This adjustment must be allocated entirely to property X, since such allocation will have the effect of reducing the difference between the value and basis of such asset. Therefore, D has a special basis adjustment of $100 with respect to property X, which now has a special basis to him of $1,100. No part of the adjustment is made to depreciable property Y or inventory items Z, since any such adjustment would increase the difference between the basis and value of each such asset.

Example (2). Assume the same facts as in example (1) of this paragraph, except that capital asset X has a value of $1,500, depreciable property Y has a value of $1,100, and inventory items Z have a value of only $400. Therefore, under section 743 (b), D has a special basis adjustment of $100, the excess of D's basis for his interest in the partnership ($1,000) over his share of the adjusted basis of partnership property ($900). This $100 adjustment must be allocated entirely to capital asset X and depreciable property Y in proportion to the difference between the value and basis of each since such allocation has the effect of reducing the difference between the value and basis of each such asset. Therefore, D has a special basis adjustment of $83 ($500/$600 of $100) with respect to capital asset X, which now has a special basis to him of $1,083, and of $17 ($100/$600 of $100) with respect to depreciable property Y, which now has a special basis to him of $1,017. No part of the adjustment is made to inventory items Z, since any such adjustment would increase the difference between the basis of such asset and its value.

Example (3). Assume that partnership EFG has three assets: X, a capital asset with an adjusted basis of $1,000 and a value of $1,500; Y, a depreciable asset with an adjusted basis of $1,000 and a value of $700; and Z, inventory items with an adjusted basis of $700 and a value of $800. E sells his interest to H (when an election under section 754 is in effect) for $1,000 (⅓ of

$3,000, the total value of the partnership assets). H's share of the adjusted basis of partnership is $900 (⅓ of $2,700). Therefore, H has a special basis adjustment of $100 ($1,000 minus $900) under section 743 (b). Since, of the total $300 difference between the value and the adjusted basis of all partnership property, $200 ($500, appreciation in value of X, minus $300, depreciation in value of Y) is attributable to the class of capital assets and depreciable property, and $100 (appreciation in value of inventory items Z) to the class of other property, H's special basis adjustment of $100 must be allocated ⅔ to capital assets and depreciable property and ⅓ to other property (inventory). The $67 increase (⅔ of $100) to be allocated to capital assets and depreciable property must further be allocated so as to reduce the difference between the value and basis of such assets. This can be done only by allocating the entire $67 increase to capital asset X (the basis of which is less than its value), and no part of the increase to depreciable property Y (the basis of which exceeds its value). Therefore, H has a special basis adjustment of $67 for capital asset X, which now has a special basis to him of $1,067; he has no special basis adjustment for depreciable property Y. H also has a special basis adjustment of $33 (⅓ of $100) for inventory items Z, the special basis of which is now $733.

DEFINITIONS

§ 1.761 Statutory provisions; terms defined.

SEC. 761. *Terms defined*—(a) *Partnership.* For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. Under regulations the Secretary or his delegate may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of—

(1) For investment purposes only and not for the active conduct of a business, or

(2) For the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted,

if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

(b) *Partner.* For purposes of this subtitle, the term "partner" means a member of a partnership.

(c) *Partnership agreement.* For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

(d) *Liquidation of a partner's interest.* For purposes of this subchapter, the term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership.

§ 1.761–1 Terms defined.

(a) *Partnership*—(1) *In general.* The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Code. The term "partnership" is broader in scope than the common law meaning of partnership, and may include groups not commonly called partnerships. See section 7701(a)(2). See regulations under section 7701(a) (1), (2), and (3) for the description of those unincorporated organizations taxable as corporations or trusts. A joint undertaking merely to share expenses is not a partnership. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they are not partners. Mere coownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a partnership thereby. Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if coowners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.

(2) *Exclusion of certain partnerships from provisions of subchapter K*—(i) *In general.* Under conditions set forth in this paragraph, an unincorporated organization described in subdivision (ii) or (iii) of this subparagraph may be excluded from the application of all or a part of the provisions of subchapter K, chapter 1 of the Code. Such organization must be availed of for investment purposes only and not for the active conduct of a business, or for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be able to compute their income without the necessity of computing partnership taxable income. Any syndicate, group, pool, or joint venture which is classifiable as an association, or any group operating under an agreement which creates an organization classifiable as an association, does not fall within these provisions.

(ii) *Investing partnership.* Where the participants in the joint purchase, retention, sale, or exchange of investment property—

(*a*) Own the property as coowners,

(*b*) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and

(*c*) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in subdivision (iv) of this subparagraph.

(iii) *Operating agreements.* Where the participants in the joint production, extraction, or use of property—

(*a*) Own the property as coowners, either in fee or under lease or other form of contract granting exclusive operating rights, and

(*b*) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and

(*c*) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than one year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in subdivision (iv) of this subparagraph. However, the preceding sentence does not apply to any unincorporated organization one of whose principal purposes is cycling, manufacturing, or processing for persons who are not members of the organization.

(iv) *Method of election*—(*a*) *Complete exclusion from subchapter K.* Any unincorporated organization described in subdivisions (i) and (ii) or (iii) of this subparagraph which wishes to be excluded from all of subchapter K must make the election provided in section 761 (a) in a statement attached to a properly executed partnership return, Form 1065, which shall contain the information required in this subdivision. Such return shall be filed with the district director for the internal revenue district in which the organization has its principal office or place of business. For the purpose of determining the district in which the organization has its principal office or place of business, the principal office or place of business of the operator shall be considered the principal office or place of business of the organization, unless the person filing for the organization is not the operator, in which case, the principal office or place of business of the person filing the return shall be considered the principal office or place of business of the organization. For the first year with respect to which such unincorporated organization wishes to be excluded from subchapter K, its partnership return shall contain, in lieu of the information required by Form 1065 and by the instructions relating thereto, only the name or other identification and the address of the organization. The statement attached to the return shall include the names and addresses of all the members of the organization; a statement that the organization qualifies under subdivisions (i) and either (ii) or (iii) of this subparagraph, a statement that all of the members of the organization elect that it be excluded from all of subchapter K; and a statement indicating where a copy of the agreement under which the organization operates is available (or if the agreement is oral, from whom the provisions of the agreement may be obtained). Unless within 90 days after the formation of the organization (or by October 15, 1956, whichever is later) any member of the organization notifies the

Commissioner that the member desires subchapter K to apply to such organization, and also advises the Commissioner that he has so notified all other members of the organization by registered or certified mail, the election to be excluded will be effective. Such election is irrevocable as long as the organization remains qualified under subdivisions (i) and either (ii) or (iii) of this subparagraph, or unless approval of revocation of the election is secured from the Commissioner. Application for permission to revoke the election must be submitted to the Commissioner of Internal Revenue, Attention: T:R, Washington, D. C., no later than 30 days after the beginning of the first taxable year to which the revocation is to apply. An unincorporated organization need not file an election to be excluded under section 761 for the first year of its existence but may do so at the time of filing the return for any taxable year for which exclusion from subchapter K is desired. Such unincorporated organization shall file a partnership return for the first taxable year in which the participants by a formal agreement undertake to engage in joint operations, or in the absence of a formal agreement for the first taxable year in which the participants with respect to the joint use of property jointly make or incur any expenditures treated as deductions for Federal income tax purposes, whether or not electing to be excluded from the provisions of subchapter K. Where no annual accounting period has been adopted by such unincorporated organization, its taxable year shall be the calendar year in accordance with section 441 (g).

(b) *Partial exclusion from subchapter K.* An unincorporated organization which wishes to be excluded from only certain sections of subchapter K must submit to the Commissioner, no later than 90 days after the beginning of the first taxable year for which partial exclusion is desired, a request for permission to be excluded from certain provisions of subchapter K. The request shall set forth the sections of subchapter K from which exclusion is sought and shall state that such organization qualifies under subdivisions (i) and either (ii) or (iii) of this subparagraph, and that the members of the organization elect to be excluded to the extent indicated. Such exclusion shall be effective only upon approval of the election by the Commissioner and subject to the conditions he may impose.

(v) *Information to be filed by organizations excluded under section 761.* (*a*) An organization which elects under subdivision (iv) (*a*) of this subparagraph to be excluded from all of subchapter K shall file the following:

(*1*) For the first taxable year for which it wishes to be excluded: a partnership return, as provided in subdivision (iv) (*a*) of this subparagraph;

(2) For each subsequent taxable year for which it is excluded: Form 1096 for the organization and a Form 1099 for each person who was a member of the organization during any part of the calendar year. Form 1099 shall show the name and address of the organization (under "By Whom Paid"). In lieu of "Kind and Amount of Income Paid", Form 1099 shall state "Filed under section 761 (a)" and the principal activity of the organization. Forms 1096 and 1099 shall be filed with the Commissioner of Internal Revenue, Midwest Service Center, Kansas City, Missouri.

(*b*) Organizations partially excluded from subchapter K shall file partnership returns containing such information as the Commissioner may require upon the granting of the partial exclusion under section 761 (a).

(b) *Partner.* The term "partner" means a member of a partnership.

(c) *Partnership agreement.* For the purposes of subchapter K, a partnership agreement includes the original agreement and any modifications thereof agreed to by all the partners or adopted in any other manner provided by the partnership agreement. Such agreement or modifications can be oral or written. A partnership agreement may be modified with respect to a particular taxable year subsequent to the close of such taxable year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return. As to any matter on which the partnership agreement, or any modification thereof, is silent, the provisions of local law shall be considered to constitute a part of the agreement.

(d) *Liquidation of partner's interest.* The term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership. A series of distributions will come within the meaning of this term whether they are made in one year or in more than one year. Where a partner's interest is to be liquidated by a series of distributions, the interest will not be considered as liquidated until the final distribution has been made. For the basis of property distributed in one liquidating distribution, or in a series of distributions in liquidation, see section 732 (b). A distribution which is not in liquidation of a partner's entire interest, as defined in this paragraph, is a current distribution. Current distributions, therefore, include distributions in partial liquidation of a partner's interest, and distributions of the partner's distributive share. See paragraph (a) (1) (ii) of § 1.731–1.

EFFECTIVE DATE FOR SUBCHAPTER K, CHAPTER 1 OF THE CODE

§ 1.771 Statutory provisions; effective date.

SEC. 771. *Effective date*—(a) *General rule*—(1) *Taxable years beginning after December 31, 1954.* Except as provided in subsection (b), this subchapter shall apply with respect to—

(A) Any partnership taxable year beginning after December 31, 1954, and

(B) Any part of a partner's taxable year falling within such partnership taxable year.

(2) *Application of prior provisions.* Except as provided in subsection (b), sections 113 (a) (13), 181 to 191 (inclusive), and 3797 (a) (2) of the Internal Revenue Code of 1939 shall apply with respect to—

(A) Any partnership taxable year beginning before January 1, 1955, and

(B) Any part of a partner's taxable year falling within such partnership taxable year.

(b) *Special rules*—(1) *Adoption of taxable year.* Section 706 (b) (relating to the adoption of a taxable year by a partnership or partner) shall apply to—

(A) Any partnership which adopts, or changes to, a taxable year beginning after April 1, 1954, and

(B) Any partner who changes to a taxable year beginning after April 1, 1954.

For the purpose of applying this paragraph, section 708 (relating to the continuation of a partnership) shall be effective for taxable years beginning after April 1, 1954.

(2) *Property distributed by a partnership.* Section 735 (a) (relating to the character of gain or loss on the disposition of property distributed by a partnership) shall apply only to property distributed by a partnership after March 9, 1954.

(3) *Unrealized receivables and inventory items.* Section 751 (relating to unrealized receivables and inventory items) shall apply with respect to gain or loss to a seller, distributee, or partnership in the case of a sale, exchange, or distribution occurring after March 9, 1954. For the purpose of applying this paragraph in the case of a taxable year beginning before January 1, 1955, the other sections of this subchapter shall be applicable to the extent provided by regulations prescribed by the Secretary or his delegate.

(4) *Partner receiving income in respect of decedent.* Section 753 (relating to income in respect of a decedent) shall apply only in the case of payments made with respect to decedents dying after December 31, 1954.

(c) *Optional treatment of certain distributions.* In the case of a partnership taxable year beginning after December 31, 1953, and before January 1, 1955, a partnership may elect, under regulations prescribed by the Secretary or his delegate, with respect to distributions made during such year to any partner, other than in liquidation of the partner's interest, to apply the rules in sections 731, 732 (a), (c), and (e), 733, 735, and 751 (b), (c), and (d) (and, to the extent applicable, the rules provided in sections 705, 752, and 761 (d)). If a partnership so elects, such rules shall be effective for the partnership and all members of such partnership with respect to such distributions.

§ 1.771–1 Effective date.

(a) *General rule.* Except as provided in paragraph (b) or (c) of this section, the provisions of subchapter K, chapter 1 of the Code, shall apply to any taxable year of a partnership beginning after December 31, 1954, and to any part of a partner's taxable year falling within such partnership taxable year. The provisions of the Internal Revenue Code of 1939 relating to partnerships shall apply to any taxable year of a partnership beginning before January 1, 1955, and to any part of a partner's taxable year falling within such partnership taxable year. If a partnership and the partners are on different taxable years, subchapter K shall become effective at the same time both for the partnership and for the partners.

(b) *Special rules.* Certain provisions of section 771 apply after specific dates in 1954, as follows:

(1) *Adoption of taxable year.* Section 706 (b) (relating to the adoption of taxable years by partners and partnerships), shall apply to any partnership which adopts or changes to, and any partner who changes to, a taxable

year beginning on or after April 2, 1954. For the purpose of applying this subparagraph, the rules of section 708 (relating to the continuation of partnerships) shall apply. For example, if two or more partnerships merge after April 1, 1954, and the new partnership uses the taxable year of the partnership of which it is deemed to be the successor under section 708 (b) (2) (A), it will not need prior approval to continue to use such taxable year even though such year may be different from the taxable years of the partners. Such a partnership is not "adopting" or "changing" its taxable year.

(2) *Property distributed by a partnership.* Section 735 (a), relating to the character of gain or loss on disposition of property distributed by a partnership to a partner, shall apply only to property distributed after March 9, 1954. Although a partnership whose taxable year begins before January 1, 1955, generally will be subject to the provisions of the Internal Revenue Code of 1939, any unrealized receivables or inventory items distributed by any such partnership after March 9, 1954, will be subject to the provisions of section 735 (a), and the gain or loss on the subsequent disposition of such property will be ordinary gain or loss rather than capital gain or loss. In the case of property distributed before March 10, 1954, section 735 (a) will not apply, even though the property is disposed of by the distributee partner after that date, unless the partnership elects under paragraph (c) of this section to apply section 735.

(3) *Unrealized receivables and inventory items.* Section 751 (providing for the realization of ordinary income on certain transfers or distributions of unrealized receivables or substantially appreciated inventory items) shall be applicable to any such transfer or distribution occurring after March 9, 1954. For the purpose of applying section 751 in the case of a taxable year beginning before January 1, 1955, a partnership or partner may elect to treat as applicable any other section of subchapter K. See paragraph (f) of § 1.751–1.

(4) *Partner receiving income in respect of a decedent.* Section 753, which provides that the amount includible in the gross income of a successor in interest of a deceased partner under section 736 (a) shall be considered income in respect of a decedent under section 691, shall apply only in the case of payments made with respect to decedents whose death occurred after December 31, 1954.

(c) *Optional treatment of certain distributions.* (1) For a partnership taxable year beginning after December 31, 1953, and before January 1, 1955, a partnership may elect to apply the rules of certain sections of subchapter K with respect to current distributions made by the partnership in such year. These sections are 731, 732 (a), (c), and (e), 733, 735, and 751 (b), (c), and (d). If an election is made, it shall apply to the partnership and all its members for all current distributions made by the partnership during the taxable year. Such distributions shall also be subject to the rules of sections 705 (relating to determination of basis of a partner's interest), 752 (relating to treatment of certain liabilities), and 761 (d) (relating to the definition of liquidation of a partner's interest), to the extent that such sections apply to current distributions.

(2) An election under this paragraph shall be made by a statement filed with the partnership return for the taxable year to which such election applies, or before August 23, 1956, whichever date is later. The statement shall be signed by all members of the partnership and the election once made shall be binding on the partnership and on all of its members.

INSURANCE COMPANIES

LIFE INSURANCE COMPANIES

§ 1.801 Statutory provisions; life insurance companies; definition of life insurance company.

SEC. 801. *Definition of life insurance company.* For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if its life insurance reserves (as defined in section 803 (b)), plus unearned premiums and unpaid losses on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves. For purposes of this section, the term "total reserves" means life insurance reserves, unearned premiums and unpaid losses not included in life insurance reserves, and all other insurance reserves required by law. A burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxable under section 802 but shall be taxable under section 821 or section 831.

§ 1.801–1 Definitions.

(a) *Life insurance company.* The term "life insurance company" as used in subtitle A of the Code is defined in section 801. For the purpose of determining whether a company is a "life insurance company" within the meaning of that term as used in section 801, it must first be determined whether the company is taxable as an insurance company under the Code. For the definition of an "insurance company", see paragraph (b) of this section. In determining whether an insurance company is a life insurance company, the life insurance reserves (as defined in section 803 (b)) plus any unearned premiums and unpaid losses on noncancellable life, health, or accident policies, not included in "life insurance reserves" must comprise more than 50 percent of its total reserves (as defined in section 801). An insurance company writing only noncancellable life, health, or accident policies and having no "life insurance reserves" may qualify as a life insurance company if its unearned premiums and unpaid losses on such policies comprise more than 50 percent of its total reserves. A noncancellable insurance policy means a contract which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premium must be carried to cover that obligation. For the purpose of the preceding sentence, the term "unearned premium" means the amount which will cover the cost of carrying the insurance risk for the period for which the premium has been paid in advance. A burial or funeral benefit insurance company qualifying as a life insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services will be taxable under section 821 or section 831 as an insurance company other than life.

(b) *Insurance companies.* (1) Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. A corporation which merely sets aside a fund for the insurance of its employees is not required to file a separate return for such fund, but the income therefrom shall be included in the return of the corporation.

(2) Though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Code. For example, during the year 1954 the M Corporation, incorporated under the insurance laws of the State of R, carried on the business of lending money in addition to guaranteeing the payment of principal and interest of mortgage loans. Of its total income for the year, one-third was derived from its insurance business of guaranteeing the payment of principal and interest of mortgage loans and two-thirds was derived from its noninsurance business of lending money. The M Corporation is not an insurance company for the year 1954 within the meaning of the Code and the regulations thereunder.

§ 1.802(a) [Reserved]

§ 1.802(b) Statutory provisions; life insurance companies; imposition of tax.

SEC. 802. *Imposition of tax.* • • •

(b) *Taxable years beginning in 1954.* In lieu of the tax imposed by subsection (a) there shall be imposed, for taxable years beginning in 1954, on the 1954 life insurance company taxable income (as defined in section 805) of every life insurance company a tax equal to the sum of the following:

(1) 3¾ percent of the amount thereof not in excess of $200,000, plus

(2) 6½ percent of the amount thereof in excess of $200,000.

§ 1.802(b)–1 Tax on life insurance companies.

(a) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, section 802(b) imposes a tax on the 1954 life insurance company taxable income of all life insurance companies (including a foreign life insurance company

carrying on a life insurance business within the United States if with respect to its United States business it would qualify as a life insurance company under section 801). The tax so imposed is equal to 3¾ percent of the amount of such income not in excess of $200,000, plus 6½ percent of the amount of such income in excess of $200,000. For the definition of the term "1954 life insurance company taxable income", see § 1.805–1.

(b) The taxable income of life insurance companies differs from the taxable income of other corporations. See section 803. Life insurance companies are entitled, in computing life insurance company taxable income, to the special deductions provided in part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code. The gross income, the deduction under section 803 (g) (1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. See section 803 (i) and § 1.803–6. Such companies are not subject to the provisions of subchapter P (section 1201 and following), chapter 1 of the Code, relating to capital gains and losses, nor to the provisions of section 171 (amortizable bond premium).

(c) All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of sections 801 to 807, inclusive, are applicable to the assessment and collection of the tax imposed by section 802, and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120L.

(d) Foreign life insurance companies not carrying on an insurance business within the United States are not taxable under section 802, but are taxable as other foreign corporations. See section 881.

§ 1.803 Statutory provisions; life insurance companies; other definitions and rules.

SEC. 803. *Other definitions and rules*—(a) *Application of section; gross income*—(1) *Application.* The definitions and rules contained in this section shall apply only in the case of life insurance companies.

(2) *Gross income.* The term "gross income" means the gross amount of income received or accrued during the taxable year from interest, dividends, and rents.

(b) *Life insurance reserves.* The term "life insurance reserves" means amounts which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies. Such life insurance reserves, except in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation and except as hereinafter provided in the case of assessment life insurance, must also be required by law. In the case of an assessment life insurance company or association, the term "life insurance reserves" includes sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained, under the charter or articles of incorporation or association (or bylaws approved by a State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued on the assessment plan and not subject to any other use.

(c) *Adjusted reserves.* The term "adjusted reserves" means life insurance reserves plus 7 percent of that portion of such reserves as are computed on a preliminary term basis.

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(e) *Reserve for deferred dividends.* The term "reserve for deferred dividends" means sums held at the end of the taxable year as a reserve for dividends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than 5 years from the date of the policy contract.

(f) *Interest paid.* The term "interest paid" means—

(1) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this chapter, and

(2) All amounts in the nature of interest, whether or not guaranteed, paid or accrued within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve, at the time of payment or accrual, life, health, or accident contingencies.

(g) *Taxable income.* The term "taxable income" means the gross income less the following deductions:

(1) *Tax-free interest.* The amount of interest received or accrued during the taxable year which under section 103 is excluded from gross income.

(2) *Investment expenses.* Investment expenses paid or incurred during the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year plus one-fourth of the amount by which taxable income (computed without any deduction for investment expenses allowed by this paragraph, for tax-free interest allowed by paragraph (1), or for partially tax-exempt interest and dividends received allowed by paragraph (5)) exceeds 3¾ percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

(3) *Real estate expenses.* Taxes and other expenses paid or accrued during the taxable year exclusively on or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed on a shareholder of a company on his interest as shareholder, which are paid or accrued by the company without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes.

(4) *Depreciation.* The depreciation deduction allowed by section 167.

(5) *Special deductions.* The special deductions allowed by part VIII of subchapter B (except section 248).

(h) *Rental value of real estate.* The deduction under subsection (g) (3) and (4) on account of any real estate owned and occupied in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this subsection) as the rental value of the space not so occupied bears to the rental value of the entire property.

(i) *Amortization of premium and accrual of discount.* The gross income, the deduction provided in subsection (g) (1), and the deduction allowed by section 242 (relating to partially tax-exempt interest) shall each be decreased to reflect the appropriate amortization of premium and increased to reflect the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such amortization and accrual shall be determined—

(1) In accordance with the method regularly employed by such company, if such method is reasonable, and

(2) In all other cases, in accordance with regulations prescribed by the Secretary or his delegate.

(j) *Double deductions.* Nothing in this part shall permit the same item to be deducted more than once.

§ 1.803–1 Life insurance reserves.

(a) The term "life insurance reserves" is defined in section 803(b). Generally, such reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. In the case of cancellable health and accident policies and similar cancellable contracts, the unearned premiums held to cover the risk for the unexpired period covered by the premiums are not included in life insurance reserves. Unpaid loss reserves for noncancellable health and accident policies are included in life insurance reserves if they are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest.

(b) In the case of an assessment life insurance company or association, life insurance reserves include sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation or association of such company or association, or bylaws (approved by the State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

(c) Life insurance reserves, except as otherwise provided in section 803 (b), must be required by law either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, but such requirement, without more, is

not conclusive; for example, life insurance reserves do not include reserves required to be maintained to provide for the ordinary running expenses of a business which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, and unpaid brokerage; nor do they include the net value of risks reinsured in other solvent companies; liability for premiums paid in advance; liability for annual and deferred dividends declared or apportioned; liability for dividends left on deposit at interest; liability for accrued but unsettled policy claims whether known or unreported; liability for supplementary contracts not involving, at the time with respect to which the liability is computed, life, health, or accident contingencies.

(d) In any case where reserves are claimed, sufficient information must be filed with the return to enable the district director to determine the validity of the claim. Only reserves which are required by law or insurance department ruling, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will, except as otherwise specifically provided in section 803 (b), be considered as life insurance reserves. A company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

(e) In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserve funds thereon be based upon recognized mortality or morbidity tables covering disability benefits of the kind contained in policies issued by this particular class of companies but they need not be required by law.

§ 1.803–2 Adjusted reserves.

For the purpose of determining "required interest" for taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, certain reserves computed on a preliminary term method are to be adjusted by increasing such reserves by 7 percent. The reserves to be thus adjusted are reserves computed on preliminary term methods, such as the Illinois Standard, or the Select and Ultimate methods. Only reserves on policies in the modification period are to be so adjusted. Where reserves under a preliminary term method are the same as on the level premium method, and in the case of reserves for extended or paid-up insurance, no adjustment is to be made. The reserves are thus adjusted, and the rate of interest on which they are computed, should be reported in Schedule A, Form 1120L.

§ 1.803–3 Interest paid or accrued.

Interest paid or accrued is one of the elements to be used in computing the amount of "required interest" for purposes of determining the reserve interest credit provided in section 805. See § 1.805–1. Interest paid or accrued consists of (a) interest paid or accrued on indebtedness (except indebtedness incurred or continued to purchase or carry tax-exempt securities as set forth in section 803 (f) (1)) and (b) amounts in the nature of interest paid or accrued on certain contracts, as provided in section 803 (f) (2). Interest on indebtedness includes interest on dividends held on deposit and surrendered during the taxable year but does not include interest paid or accrued on deferred dividends. Life insurance reserves as defined in § 1.803–1 are not indebtedness. Dividends left with the company to accumulate at interest are a debt and not a reserve liability. Amounts in the nature of interest include so-called excess-interest dividends as well as guaranteed interest paid or accrued within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which, at the time of payment, do not involve life, health, or accident contingencies. It is immaterial whether the optional mode of settlement specified in the insurance or annuity contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by a beneficiary after the policy has matured, frequently referred to as a supplementary contract not involving life contingencies; for example, a contract to pay the insurance benefit in 10 annual installments. No distinction is made based on the person choosing the method of payment, and the full amount of the interest paid or accrued and not merely the guaranteed interest is considered as interest paid or accrued.

§ 1.803–4 Taxable income and deductions.

(a) *In general.* The taxable income of a life insurance company is its gross amount of income received or accrued during the taxable year from interest, dividends, and rents, less the deductions provided in section 803(g) for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, and the special deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code. In addition to the limitations on deductions relating to real estate owned and occupied by a life insurance company provided in section 803 (h), the limitations on the adjustment for amortization of premium and accrual of discount provided in section 803 (i), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 803 (g) (2), life insurance companies are subject to the limitations on deductions relating to wholly tax-exempt income provided in section 265. Life insurance companies are not entitled to the net operating loss deduction provided in section 172.

(b) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross income of a life insurance company by section 803 (a) (2) is allowed as a deduction from gross income by section 803 (g) (1).

(c) *Investment expenses.* (1) As used in the Code, the term "general expenses" means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. Any assignment of such expense to the investment department of the company for which a deduction is claimed under section 803(g)(2) subjects the entire deduction for investment expenses to the limitation provided in that section. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes.

(2) If no general expenses are assigned to or included in investment expenses the deduction may consist of investment expenses paid or incurred during the taxable year in which case an itemized schedule of such expenses must be appended to the return.

(3) Invested assets for the purpose of section 803 (g) (2) and this section are those which are owned and used, and to the extent used, for the purpose of producing the income specified in section 803 (a) (2). They do not include real estate owned and occupied, and to the extent owned and occupied, by the company. If general expenses are assigned to or included in investment expenses, the maximum allowance will not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses.

(d) *Taxes and expenses with respect to real estate.* The deduction for taxes and expenses under section 803 (g) (3) includes taxes and expenses paid or accrued during the taxable year exclusively upon or with respect to real estate owned by the company and any sum representing taxes imposed upon a shareholder of the company upon his interest as shareholder which is paid or accrued by the company without reimbursement from the shareholder. No deduction shall be allowed, however, for taxes, expenses, and depreciation upon or with respect to any real estate owned by the company except to the extent used for the purpose of producing investment income. See paragraph (c) of this section. As to real estate owned and occupied by the company, see § 1.803–5.

(e) *Depreciation.* The deduction allowed for depreciation is, except as provided in section 803 (h), identical with that allowed other corporations by section 167. The amount allowed by section 167 in the case of life insurance companies is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 803 (a) (2).

§ 1.803–5 Real estate owned and occupied.

The amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a life insurance company is limited to an amount which bears the

same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

§ 1.803–6 Amortization of premium and accrual of discount.

(a) Section 803(i) provides for certain adjustments on account of amortization of premium and accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases, and for accrual of discount increases, (1) the gross income, (2) the deduction for wholly tax-exempt interest, and (3) the deduction for partially tax-exempt interest.

(b) The premium for any such security is the excess of its acquisition value over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, then its fair market value. The maturity value of any such security is the amount payable thereunder either at the maturity date or an earlier call date. The earlier call date of any such security may be the earliest call date specified therein as a day certain, the earliest interest payment date if it is callable or payable at such date, the earliest date at which it is callable at par, or such other call or payment date, prior to maturity, specified in the security as may be selected by the life insurance company. A life insurance company which adjusts amortization of premium or accrual of discount with reference to a particular call or payment date must make the adjustments with reference to the value on such date and may not, after selecting such date, use a different call or payment date, or value, in the calculation of such amortization or discount with respect to such security unless the security was not in fact called or paid on such selected date.

(c) The adjustments for amortization of premium and accrual of discount will be determined—

(1) According to the method regularly employed by the company, if such method is reasonable, or

(2) According to the method prescribed by this section.

A method of amortization of premium or accrual of discount will be deemed "regularly employed" by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before made such adjustments, the company initiates in the first taxable year for which the adjustments are made a reasonable method of amortization of premium or accrual of discount and consistently follows such method thereafter. Ordinarily, a company regularly employs a method in accordance with the statute of some State, Territory, or the District of Columbia, in which it operates.

(d) The method of amortization and accrual prescribed by this section is as follows:

(1) The premium (or discount) shall be determined in accordance with this section; and

(2) The appropriate amortization of premium (or accrual of discount) attributable to the taxable year shall be an amount which bears the same ratio to the premium (or discount) as the number of months in the taxable year during which the security was owned by the life insurance company bears to the number of months between the date of acquisition of the security and its maturity or earlier call date, determined in accordance with this section. For the purpose of this section, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month.

§ 1.804 [Rserved]

§ 1.805 Statutory provisions; life insurance companies; life insurance company taxable income.

SEC. 805. *1954 life insurance company taxable income*—(a) *Definition.* For purposes of section 802 (b), the term "1954 life insurance company taxable income" means the taxable income (as defined in section 803 (g)), plus 8 times the amount of the adjustment for certain reserves provided in section 806, and minus the reserve interest credit, if any, provided in subsection (b) of this section.

(b) *Reserve interest credit.* For purposes of subsection (a), the reserve interest credit shall be an amount determined as follows:

(1) Divide the amount of the adjusted taxable income (as defined in subsection (c)) by the amount of the required interest (as defined in subsection (d)).

(2) If the quotient obtained in paragraph (1) is 1.05 or more, the reserve interest credit shall be zero.

(3) If the quotient obtained in paragraph (1) is 1.00 or less, the reserve interest credit shall be an amount equal to 50 percent of the taxable income.

(4) If the quotient obtained in paragraph (1) is more than 1.00 but less than 1.05, the reserve interest credit shall be the amount obtained by multiplying the taxable income by 10 times the difference between the figures 1.05 and such quotient.

(c) *Adjusted taxable income.* For purposes of subsection (b) (1), the term "adjusted taxable income" means the taxable income (computed without the deductions provided in section 803 (g) (1) or (5)) minus 50 percent of the amount of the adjustment for certain reserves provided in section 806.

(d) *Required interest.* For purposes of subsection (b) (1), the term "required interest" means the total of—

(1) The sum of the amounts obtained by multiplying—

(A) Each rate of interest assumed in computing the taxpayer's life insurance reserves by

(B) The means of the amounts of the taxpayer's adjusted reserves computed at that rate at the beginning and end of the taxable year,

(2) 2 percent of the reserve for deferred dividends, and

(3) Interest paid.

§ 1.805–1 Tax on life insurance companies in the case of a taxable year beginning in 1954.

(a) Section 802(b) imposes a tax on the "1954 life insurance company taxable income" of all life insurance companies for taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954. See paragraph (a) of § 1.802(b)–1.

(b) For purposes of section 802 (b), the term "1954 life insurance company taxable income" means the taxable income (consisting of income computed as provided in § 1.803–4) for the taxable year beginning in 1954 plus eight times the amount of the adjustment for certain reserves computed as provided in section 806 (see § 1.806–1), and minus the reserve interest credit, if any, provided in section 805 (b) (see § 1.805–2).

§ 1.805–2 Reserve interest credit.

(a) In computing 1954 life insurance company taxable income, a reserve interest credit is allowed where the "adjusted taxable income" of the company is less than 105 percent of its required interest. For the purpose of computing the reserve interest credit, the term "adjusted taxable income" means the taxable income of the company computed without the deductions provided in section 803(g) (1) or (5), less 50 percent of the adjustment for certain reserves on contracts other than life insurance or annuity contracts provided in section 806.

(b) The required interest for which a credit may be allowed consists of the total of—

(1) The sum of amounts obtained by multiplying each rate of interest assumed in computing life insurance reserves (see section 803 (b) and § 1.803–1) by the means of the amounts of the adjusted reserves, as defined in section 803 (c), computed at that rate at the beginning and the end of the taxable year;

(2) Two percent of the reserve for deferred dividends; and

(3) Interest paid or accrued.

(c) To determine the amount of the reserve interest credit, it is necessary to divide the amount of the adjusted taxable income by the amount of the required interest. If the adjusted taxable income is 100 percent or less of the required interest, the reserve interest credit is an amount equal to 50 percent of the life insurance company taxable income. If the adjusted taxable income is 105 percent or more of the required interest, the reserve interest credit is zero. If the adjusted taxable income is more than 100 percent and less than 105 percent of the required interest, the reserve interest

credit is computed by multiplying the life insurance company taxable income by ten times the difference between 105 percent and the percentage established. Thus, if the adjusted taxable income of a life insurance company for the calendar year 1954 is $103,000 and the required interest for such year is $100,000, the adjusted taxable income is 103 percent of the required interest and the reserve interest, accordingly, is the life insurance company taxable income multiplied by 20 percent (10 times 2 percent, the difference between 105 percent and 103 percent).

(d) In determining the percentage of the adjusted taxable income to required interest for purposes of determining the reserve interest credit, the figures shall be computed to at least the nearest one-tenth of a percentage point.

§ 1.806 Statutory provisions; life insurance companies; adjustment for certain reserves.

SEC. 806. *Adjustment for certain reserves.* In the case of a life insurance company writing contracts other than life insurance or annuity contracts (either separately or combined with noncancellable health and accident insurance), the term "adjustment for certain reserves" means an amount equal to 3¼ percent of the unearned premiums and unpaid losses on such other contracts which are not included in life insurance reserves (as defined in section 803 (b). For purposes of this section, such unearned premiums shall not be considered to be less than 25 percent of the net premiums written during the taxable year on such other contracts.

§ 1.806–1 Adjustment for certain reserves.

(a) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, a life insurance company writing contracts other than life insurance or annuity contracts (either separately or combined with noncancellable health and accident insurance contracts) must add to its life insurance company taxable income (as a factor in determining 1954 adjusted taxable income) an amount equal to eight times the amount of the adjustment for certain reserves provided in paragraph (b) of this section.

(b) The adjustment for certain reserves referred to in paragraph (a) of this section shall be an amount equal to 3¼ percent of the mean of the unearned premiums and unpaid losses at the beginning and end of the taxable year on such other contracts as are not included in life insurance reserves. If such unearned premiums, however, are less than 25 percent of the net premiums written during the taxable year on such other contracts, then the adjustment shall be 3¼ percent of 25 percent of the net premiums written during the taxable year on such other contracts plus 3¼ percent of the mean of the unpaid losses at the beginning and end of the taxable year on such other contracts. As used in this section, the term "unearned premiums" has the same meaning as in section 832 (b) (4) and § 1.832–1.

§ 1.807 Statutory provisions; life insurance companies; foreign life insurance companies.

SEC. 807. *Foreign life insurance companies* (a) *Carrying on United States insurance business.* A foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, shall be taxable in the same manner as a domestic life insurance company; except that the determinations necessary for purposes of this subtitle shall be made on the basis of the income, disbursements, assets, and liabilities reported in the annual statement for the taxable year of the United States business of such company on the form approved for life insurance companies by the National Association of Insurance Commissioners.

(b) *No United States insurance business.* Foreign life insurance companies not carrying on an insurance business within the United States shall not be taxable under this section but shall be taxable as other foreign corporations.

§ 1.807–1 Foreign life insurance companies.

A foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, is taxable on its income received during the taxable year from interest, dividends, and rents, from sources within and without the United States, pertaining to its United States business. Such a company is taxable in the same manner as a domestic life insurance company except that the determinations necessary for the purposes of subtitle A, such as gross income, the adjustment for certain reserves, deductions and limitations on deductions, amortization of premiums and accrual of discount, and the deductions allowed the company in part VIII, subchapter B, chapter 1 of the Code, shall be made on the basis of the income, disbursements, assets, and liabilities reported in the annual statement for the taxable year of the United States business of such company on the form approved for life insurance companies by the National Association of Life Insurance Commissioners. This statement is presumed to reflect the income, disbursements, assets, and liabilities of the United States business of the company and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose.

MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE OR MARINE OR FIRE INSURANCE COMPANIES ISSUING PERPETUAL POLICIES)

§ 1.821 Statutory provisions; tax on mutual insurance companies (other than life or marine or fire insurance companies issuing perpetual policies).

SEC. 821. *Tax on mutual insurance companies (other than life or marine or fire insurance companies issuing perpetual policies)*—(a) *Imposition of tax on mutual companies other than interinsurers.* There shall be imposed for each taxable year on the income of every mutual insurance company (other than a life or a marine insurance company or a fire insurance company subject to the tax imposed by section 831 and other than an interinsurer or reciprocal underwriter) a tax computed under paragraph (1) or paragraph (2), whichever is the greater:

(1) If the mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) is over $3,000, a tax computed as follows:

(A) *Normal tax*—(i) *Taxable years beginning before April 1, 1955.* In the case of taxable years beginning before April 1, 1955, a normal tax of 30 percent of the mutual insurance company taxable income, or 60 percent of the amount by which such taxable income exceeds $3,000, whichever is the lesser;

* * * * *

(B) *Surtax.* A surtax of 22 percent of the mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) in excess of $25,000.

(2) If for the taxable year the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus the interest which under section 103 is excluded from gross income, exceeds $75,000, a tax equal to 1 percent of the amount so computed, or 2 percent of the excess of the amount so computed over $75,000, whichever is the lesser.

(b) *Imposition of tax on interinsurers.* In the case of every mutual insurance company which is an interinsurer or reciprocal underwriter (other than a life or a marine insurance company or a fire insurance company subject to the tax imposed by section 831), if the mutual insurance company taxable income (computed as provided in subsection (a) (1)) is over $50,000, there shall be imposed for each taxable year on the mutual insurance company taxable income a tax computed as follows:

(1) *Normal tax*—(A) *Taxable years beginning before April 1, 1955.* In the case of taxable years beginning before April 1, 1955, a normal tax of 30 percent of the mutual insurance company taxable income, or 60 percent of the amount by which such taxable income exceeds $50,000, whichever is the lesser;

* * * * *

(2) *Surtax.* A surtax of 22 percent of the mutual insurance company taxable income (computed as provided in subsection (a) (1)) in excess of $25,000, or 33 percent of the amount by which such taxable income exceeds $50,000, whichever is the lesser.

(c) *Gross amount received, over $75,000 but less than $125,000.* If the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 but less than $125,000, the tax imposed by subsection (a) or subsection (b), whichever applies, shall be reduced to an amount which bears the same proportion to the amount of the tax determined under such subsection as the excess over $75,000 of such gross amount received bears to $50,000.

(d) *No United States insurance business.* Foreign mutual insurance companies (other than a life or marine insurance company or a fire insurance company subject to the tax imposed by section 831) not carrying on an insurance business within the United States shall not be subject to this part but shall be taxable as other foreign corporations.

(e) *Alternative tax on capital gains.* For alternative tax in case of capital gains, see section 1201 (a).

§ 1.821–1 Tax on mutual insurance companies other than life or marine or fire insurance companies subject to the tax imposed by section 831.

(a) *In general.* (1) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, all mutual insurance companies, including foreign insurance companies carrying on an insurance

business within the United States, not taxable under section 801 or 831 and not specifically exempt under the provisions of section 501(c)(15), are subject to the tax imposed by section 821 on their investment income or on their gross income, whichever tax is the greater, except interinsurers and reciprocal underwriters which are taxed only on their investment income. For the alternative tax, in lieu of the tax imposed by section 821 (a) or (b), where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

(2) The taxable income of mutual insurance companies subject to the tax imposed by section 821 differs from the taxable income of other corporations. See section 821 (a) (2) and section 822. Such companies are entitled, in computing mutual insurance company taxable income, to the deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code. The gross amount of income during the taxable year from interest, the deduction under section 822(c)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. See section 822 (d) (2) and § 1.822–3.

(3) All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of section 821 are applicable to the assessment and collection of the tax imposed by section 821 (a) or (b) and mutual insurance companies subject to the tax imposed by section 821 are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120M.

(4) Foreign mutual insurance companies not carrying on an insurance business within the United States are not taxable under section 821 (a) or (b), but are taxable as other foreign corporations. See section 881.

(5) Mutual insurance companies subject to the tax imposed by section 821, except interinsurers or reciprocal underwriters, with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $3,000 or with gross amounts of income from interest, dividends, rents, and net premiums (minus dividends to policyholders and wholly tax-exempt interest) in excess of $75,000, are subject to a tax computed under section 821 (a) (1) or section 821 (a) (2) whichever is the greater. Interinsurers and reciprocal underwriters with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $50,000 are subject to a tax computed under section 821 (b).

(b) *Rates of tax.* (1) The normal tax under section 821 (a) (1) (A) and 821 (b) (1), except as hereinafter indicated, is computed upon mutual insurance company taxable income for purposes of the normal tax at the rate of 30 percent.

(2) The surtax under section 821 (a) (1) (B) and 821 (b) (2), except as hereinafter indicated, is computed on that portion of the mutual insurance company taxable income for purposes of the surtax in excess of $25,000 at the rate of 22 percent. The tax under section 821 (a) (2), except as hereinafter indicated, is 1 percent of the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest.

(3) Under section 821 (a) (1) (A) companies with mutual insurance company taxable income for purposes of the normal tax of over $3,000 and not over $6,000 pay a normal tax, at a specified rate, on that portion of such income in excess of $3,000. The rate applicable in computing the normal tax of such companies is 60 percent. Under section 821 (a) (2) companies with gross amounts of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest, of over $75,000 and not over $150,000 pay a tax equal to 2 percent of that portion in excess of $75,000.

(4) Under section 821 (b) (1) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the normal tax of over $50,000 and not over $100,000 pay a normal tax computed on that portion of such income in excess of $50,000 at the rate of 60 percent. Under section 821 (b) (2) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the surtax of over $50,000 and not over $100,000 pay a surtax, at the rate of 33 percent, on that portion of such income in excess of $50,000.

(5) Section 821 (c) provides for an adjustment of the amount computed under section 821 (a) (1), section 821 (a) (2), and section 821 (b) where the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 and less than $125,000. The adjustment reduces the tax otherwise computed under those sections to an amount which bears the same proportion to such tax as the excess over $75,000 bears to $50,000.

(c) *Application.* The application of section 821 (a) to (c) inclusive, may be illustrated by the following examples:

Example (1). The W Company, a mutual casualty insurance company, for the calendar year 1954, has mutual insurance company taxable income for purposes of the surtax of $5,500 and, due to partially tax-exempt interest of $800, has income for purposes of the normal tax of $4,700. The gross amount of income of the W Company from interest, dividends, rents and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $150,000. Its normal tax under section 821 (a) (1) for the calendar year 1954 is 60 percent of $1,700 ($4,700 minus $3,000) or $1,020, since its income subject to normal tax is not over $6,000. It is not liable for surtax for the calendar year 1954 as its mutual insurance company taxable income for purposes of the surtax does not exceed $25,000. It has no surtax and, therefore, its total tax under section 821 (a) (1) (A) is the normal tax of $1,020. The tax under section 821 (a) (2) is 2 percent of $75,000 ($150,000—$75,000), or $1,500. Since the tax under section 821 (a) (2) exceeds the tax under section 821 (a) (1), the tax under section 821 is $1,500, namely, that imposed by section 821 (a) (2).

Example (2). If in example (1) the income for purposes of the normal tax were not over $3,000, the income for purposes of the surtax were not over $25,000, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) were $90,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, were $70,000, the W Company would be required to file an income tax return but due to section 821 (a) no income tax would be imposed.

Example (3). The X Company, a mutual casualty insurance company, for the calendar year 1954 has mutual insurance company taxable income for surtax purposes of $28,000 and, due to partially tax-exempt interest of $5,000, has income for normal tax purposes of $23,000. The gross amount of income of the X Company from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $1,200,000. Under section 821 (a) (1) its normal tax for the calendar year 1954 is 30 percent of $23,000, or $6,900, and the surtax is 22 percent of $3,000 ($28,000—$25,000), or $660. The combined tax under section 821 (a) (1) is $7,560 ($6,900 plus $660). The tax under section 821 (a) (2) is 1 percent of $1,200,000, or $12,000. Since the tax under section 821 (a) (2) exceeds the tax under section 821 (a) (1), the tax under section 821 (a) is $12,000, namely, that imposed by section 821 (a) (2).

Example (4). The Y Company, a mutual fire insurance company subject to the tax imposed by section 821 for the calendar year 1954, has mutual insurance company taxable income for purposes of the surtax of $35,000 and, due to partially tax-exempt interest of $5,000, has income for purposes of the normal tax of $30,000. The gross amount received from interest, dividends, rents and premiums (including deposits and assessments) is $120,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $100,000. Under section 821 (a) (1), without application of section 821 (c), the normal tax would be 30 percent of $30,000, or $9,000, since this is less than $16,200, 60 percent of $27,000 (excess of $30,000 over $3,000); and the surtax would be 22 percent of $10,000 (excess of $35,000 over $25,000), or $2,200. The combined tax of $11,200 ($9,000 plus $2,200) would then be reduced by applying section 821 (c), since the gross receipts are between $75,000 and $125,000. The tax under section 821 (a) (1), as thus adjusted, would be 90 percent of $11,200, or $10,080, since $45,000 (excess of $120,000 over $75,000) is 90 percent of $50,000. Under section 821 (a) (2), without reference to section 821 (c), the tax is 2 percent of $25,000 (excess of $100,000 over $75,000), or $500, since this is less than $1,000, 1 percent of $100,000. Applying section 821 (c) reduces this to $450, or 90 percent of $500. Since $10,080, the tax under section 821 (a) (1), as adjusted, exceeds $450, the tax under section 821 (a) (2), as adjusted, the tax under section 821 (a) (1), as adjusted, is applicable. The Y Company would accordingly pay a combined normal tax and surtax of $10,080.

Example (5). The Z Exchange, an interinsurer, for the calendar year 1954 has mutual insurance company taxable income for purposes of the surtax of $60,000 and, due to partially tax-exempt interest of $12,000, has income for purposes of the normal tax of $48,000. The gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is $2,700,000. The Z Exchange is not liable for normal tax under section 821 (b) (1) for the calendar year 1954 as its mutual insurance company taxable income for purposes of the normal tax does not exceed $50,000. Its surtax is 33 percent of $10,000 ($60,000 minus $50,000), or $3,300, since that amount is less than $7,700, 22 percent of $35,000 (excess of $60,000 over $25,000). Since the Z Exchange has no normal tax, is not subject to the tax imposed by section 821 (a) (2), and is not entitled to the adjustment provided in section 821 (c), its total tax under section 821 (a) is $3,300.

§ 1.822 Statutory provisions; determination of mutual insurance company taxable income.

SEC. 822. *Determination of mutual insurance company taxable income*—(a) *Definition.* For purposes of section 821, the term "mutual insurance company taxable income" means the gross investment income minus the deductions provided in subsection (c).

(b) *Gross investment income.* For purposes of subsection (a), the term "gross investment income" means the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets to the extent provided in subchapter P (sec. 1201 and following, relating to capital gains and losses).

(c) *Deductions.* In computing mutual insurance company taxable income, the following deductions shall be allowed:

(1) *Tax-free interest.* The amount of interest which under section 103 is excluded for the taxable year from gross income.

(2) *Investment expenses.* Investment expenses paid or accrued during the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year plus one-fourth of the amount by which mutual insurance company taxable income (computed without any deduction for investment expenses allowed by this paragraph, for tax-free interest allowed by paragraph (1), or for partially tax-exempt interest and dividends received allowed by paragraph (7)), exceeds 3¾ percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

(3) *Real estate expenses.* Taxes and other expenses paid or accrued during the taxable year exclusively on or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed on a shareholder of a company on his interest as shareholder, which are paid or accrued by the company without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes.

(4) *Depreciation.* The depreciation deduction allowed by section 167.

(5) *Interest paid or accrued.* All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest on which is wholly exempt from taxation under this subtitle.

(6) *Capital losses.* Capital losses to the extent provided in subchapter P (sec. 1201 and following) plus losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Capital assets shall be considered as sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders to the extent that the gross receipts from their sale or exchange are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, losses paid, and expenses paid over the sum of interest, dividends, rents, and net premiums received. In the application of section 1211 for purposes of this section, the net capital loss for the taxable year shall be the amount by which losses for such year from sales or exchanges of capital assets exceeds the sum of the gains from such sales or exchanges and whichever of the following amounts is the lesser;

(A) The mutual insurance company taxable income (computed without regard to gains or losses from sales or exchanges of capital assets or to the deduction provided in section 242 for partially tax-exempt interest); or

(B) Losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders.

(7) *Special deductions.* The special deductions allowed by part VIII (except section 248) of subchapter B (sec. 241 and following, relating to partially tax-exempt interest and to dividends received).

(d) *Other applicable rules*—(1) *Rental value of real estate.* The deduction under subsection (c) (3) or (4) on account of any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 shall be limited to an amount which bears the same ratio to such deductions (computed without regard to this paragraph) as the rental value of the space not so occupied bears to the rental value of the entire property.

(2) *Amortization of premium and accrual of discount.* The gross amount of income during the taxable year from interest, the deduction provided in subsection (c) (1), and the deduction allowed by section 242 (relating to partially tax-exempt interest) shall each be decreased to reflect the appropriate amortization of premium and increased to reflect the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. Such amortization and accrual shall be determined—

(A) In accordance with the method regularly employed by such company, if such method is reasonable, and

(B) In all other cases, in accordance with regulations prescribed by the Secretary or his delegate.

(3) *Double deductions.* Nothing in this part shall permit the same item to be deducted more than once.

(e) *Foreign mutual insurance companies other than life or marine.* In the case of a foreign mutual insurance company (other than a life or marine insurance company or a fire insurance company subject to the tax imposed by section 831), the mutual insurance company taxable income shall be the taxable income from sources within the United States (computed without regard to the deductions allowed by subsection (c) (7)), and the gross amount of income from the interest, dividends, rents, and net premiums shall be the amount of such income from sources within the United States. In the case of a company to which the preceding sentence applies, the deductions allowed in this section shall be allowed to the extent provided in subpart B of part II of subchapter N (sec. 881 and following) in the case of a foreign corporation engaged in trade or business within the United States.

§ 1.822–1 Taxable income and deductions.

(a) *In general.* For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, the taxable income of a mutual insurance company subject to the tax imposed by section 821 is its gross investment income, namely, the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets, less the deductions provided in section 822 (c) for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accrued, capital losses to the extent provided in subchapter P (sec. 1201 and following), chapter 1 of the Code, and the special deductions provided in part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 821 provided in section 822(d)(1), the adjustment for amortization of premium and accrual of discount provided in section 822(d)(2), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 822(c)(2), mutual insurance companies subject to the tax imposed by section 821 are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 265. Such companies are not entitled to the net operating loss deduction provided in section 172.

(b) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross investment income by section 822 (b) is allowed as a deduction from gross investment income by section 822 (c) (1).

(c) *Investment expenses.* The deduction allowed by section 822 (c) (2) for investment expenses is the same as that allowed life insurance companies by section 803 (g) (2). See paragraph (c) of § 1.803–4.

(d) *Taxes and expenses with respect to real estate.* The deduction allowed by section 822 (c) (3) for taxes and expenses with respect to real estate owned by the company is the same as that allowed life insurance companies by section 803 (g) (3). See paragraph (d) of § 1.803–4.

(e) *Depreciation.* The deduction allowed by section 822 (c) (4) for depreciation is the same as that allowed life insurance companies by section 803 (g) (4). See paragraph (e) of § 1.803–4.

(f) *Interest paid or accrued.* The deduction allowed by section 822 (c) (5)

for interest on indebtedness is the same as that allowed other corporations by section 163. See § 1.163–1.

(g) *Capital losses.* (1) The deduction for capital losses under section 822 (c) (6) includes not only capital losses to the extent provided in subchapter P but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under subchapter P is limited to the gains. See section 1211.

(2) Capital assets are considered as sold or exchanged to provide for the funds or payments specified in section 822 (c) (6), to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of interest, dividends, rents, and net premiums received. If, by reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital losses subject to the provisions of subchapter P. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 1212.

(3) The application of section 822 (c) (6) may be illustrated by the following examples:

Example (1). The X Company, a mutual fire insurance company subject to the tax imposed by section 821, in the taxable year 1954 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,000. It pays dividends to policyholders of $150,000. It sustains losses of $25,000, and pays expenses of $25,000. It receives interest of $50,000, dividends of $5,000, rents of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses, and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000) is $75,000. As the gross receipts from the sale of capital assets ($60,000) do not exceed such excess ($75,000), the losses of $20,000 are allowable as a deduction from gross investment income.

Example (2). If in example (1) the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under subchapter P.

Example (3). If in example (1) the X Company had mutual insurance company taxable income for purposes of the surtax of $9,750 and, under the provisions of subchapter P, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1954, in applying section 1212 for the purposes of section 822 (c) (6), would be $8,000. This is determined by subtracting from total losses of $38,000 ($18,000 capital losses under subchapter P plus $20,000 other capital losses under section 822 (c) (6)) the sum of capital gains of $10,000 and losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,000 are added to capital gains of $10,000, since they are less than taxable income for purposes of the surtax, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 taxable income for purposes of the surtax plus $20,000 other capital losses under section 822 (c) (6) plus the portion of capital losses allowable under subchapter P of $10,000 minus capital gains under subchapter P of $10,000).

(h) *Special deductions.* Section 822 (c) (7) allows a mutual insurance company the special deductions provided by part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code, relating to partially tax-exempt interest and to dividends received.

§ 1.822–2 Real estate owned and occupied.

The limitation in section 822(d)(1) on the amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 is the same as that provided in the case of life insurance companies by section 803 (h). See § 1.803–5.

§ 1.822–3 Amortization of premium and accrual of discount.

Section 822(d)(2) makes provision for the appropriate amortization of premium and the appropriate accrual of discount, attributable to the taxable year, on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. Such amortization and accrual is the same as that provided for life insurance companies by section 803(i) and shall be determined in accordance with § 1.803–6, except that in determining the premium and discount of a mutual insurance company subject to the tax imposed by section 821 the basis provided in section 1012 shall be used in lieu of the acquisition value.

§ 1.823 Statutory provisions; other definitions.

SEC. 823. *Other definitions.* For purposes of this part—

(1) *Net premiums.* The term "net premiums" means gross premiums (including deposits and assessments) written or received on insurance contracts during the taxable year less return premiums and premiums paid or incurred for reinsurance. Amounts returned where the amount is not fixed in the insurance contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums but shall be treated as dividends to policyholders under paragraph (2).

(2) *Dividends to policyholders.* The term "dividends to policyholders" means dividends and similar distributions paid or declared to policyholders. For purposes of the preceding sentence, the term "paid or declared" shall be construed according to the method regularly employed in keeping the books of the insurance company.

§ 1.823–1 Net premiums.

Net premiums are one of the items used, together with interest, dividends, and rents, less dividends to policyholders and wholly tax-exempt interest, in determining tax liability under section 821 (a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term "net premiums" is defined in section 823(1) and includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 823(2).

§ 1.823–2 Dividends to policyholders.

(a) Dividends to policyholders is one of the deductions used, together with wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term "dividends to policyholders" is defined in section 823 (2) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such amounts are not to be treated as return premiums under section 823 (1). Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual fire insurance companies. The term "paid or declared" is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed as follows:

To dividends and similar distributions paid during the taxable year add the amount of dividends and similar distributions declared but unpaid at the end of the taxable year and deduct dividends and similar distributions declared but unpaid at the beginning of the taxable year.

If an insurance company using the accrual method does not compute the deduction for dividends and similar distributions declared to policyholders in the manner stated, it must submit with its return a full and complete explanation of the manner in which the deduction is computed. For the rule as to when dividends are considered paid, see the regulations under section 561.

OTHER INSURANCE COMPANIES

§ 1.831 Statutory provisions; tax on insurance companies (other than life or mutual), mutual marine insurance companies, and mutual fire insurance companies issuing perpetual policies.

SEC. 831. *Tax on insurance companies (other than life or mutual), mutual marine insurance companies, and mutual fire insurance companies issuing perpetual policies*—(a) *Imposition of tax.* Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company (other than a life or mutual insurance company), every mutual marine insurance company, and every mutual fire insurance company exclusively issuing either perpetual policies or policies for which the sole premium charged is a single deposit which (except for such deduction of underwriting costs as may be provided) is refundable on cancellation or expiration of the policy.

(b) *No United States insurance business.* Foreign insurance companies (other than a life or mutual insurance company), foreign mutual marine insurance companies, and foreign mutual fire insurance companies described in subsection (a), not carrying on an insurance business within the United States, shall not be subject to this part but shall be taxable as other foreign corporations.

(c) *Alternative tax on capital gains.* For alternative tax in case of capital gains, see section 1201 (a).

§ 1.831–1 Tax on insurance companies (other than life or mutual), mutual marine insurance companies, and mutual fire insurance companies issuing perpetual policies.

(a) All insurance companies, other than life or mutual or foreign insurance companies not carrying on an insurance business within the United States, and all mutual marine insurance companies and mutual fire insurance companies exclusively issuing either perpetual policies, or policies for which the sole premium charged is a single deposit which, except for such deduction of underwriting costs as may be provided, is refundable upon cancellation or expiration of the policy, are subject to the tax imposed by section 831. As used in this section and §§ 1.832–1 and 1.832–2, the term "insurance companies" means only those companies which qualify as insurance companies under the definition provided by paragraph (b) of § 1.801–1 and which are subject to the tax imposed by section 831.

(b) All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of section 831 are applicable to the assessment and collection of the tax imposed by section 831(a), and insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations.

(c) Since section 832 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the returns under section 831 shall be made on the basis of the calendar year and shall be on Form 1120. Insurance companies are entitled, in computing insurance company taxable income, to the deductions provided in part VIII (section 241 and following), subchapter B, chapter 1 of the Code.

(d) Foreign insurance companies not carrying on an insurance business within the United States are not taxable under section 831 but are taxable as other foreign corporations. See section 881.

(e) Insurance companies are subject to both normal tax and surtax. The normal tax shall be computed as provided in section 11 (b) and the surtax shall be computed as provided in section 11 (c). For the circumstances under which the $25,000 exemption from surtax for certain taxable years may be disallowed in whole or in part, see section 1551. For alternative tax where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201 (a) and the regulations thereunder.

§ 1.832 Statutory provisions; insurance company taxable income.

SEC. 832. *Insurance company taxable income*—(a) *Definition of taxable income.* In the case of an insurance company subject to the tax imposed by section 831, the term "taxable income" means the gross income as defined in subsection (b) (1) less the deductions allowed by subsection (c).

(b) *Definitions.* In the case of an insurance company subject to the tax imposed by section 831—

(1) *Gross income.* The term "gross income" means the sum of—

(A) The combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners.

(B) Gain during the taxable year from the sale or other disposition of property, and

(C) All other items constituting gross income under subchapter B, except that, in the case of a mutual fire insurance company described in section 831 (a), the amount of single deposit premiums paid to such company shall not be included in gross income.

(2) *Investment income.* The term "investment income" means the gross amount of income earned during the taxable year from interest, dividends, and rents, computed as follows: To all interest, dividends, and rents received during the taxable year, add interest, dividends, and rents due and accrued at the end of the taxable year, and deduct all interest, dividends, and rents due and accrued at the end of the preceding taxable year.

(3) *Underwriting income.* The term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

(4) *Premiums earned.* The term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

(A) From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance.

(B) To the result so obtained, add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year.

For purposes of this subsection, unearned premiums shall include life insurance reserves, as defined in section 806, pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 831 and not qualifying as a life insurance company under section 801.

(5) *Losses incurred.* The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

(A) To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year.

(B) To the result so obtained, add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year.

(6) *Expenses incurred.* The term "expenses incurred" means all expenses shown on the annual statement approved by the National Convention of Insurance Commissioners, and shall be computed as follows: To all expenses paid during the taxable year, add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the taxable income subject to the tax imposed by section 831, there shall be deducted from the expenses incurred (as defined in this paragraph) all expenses incurred which are not allowed as deductions by subsection (c).

(c) *Deductions allowed.* In computing the taxable income of an insurance company subject to the tax imposed by section 831, there shall be allowed as deductions:

(1) All ordinary and necessary expenses incurred, as provided in section 162 (relating to trade or business expenses);

(2) All interest, as provided in section 163;

(3) Taxes, as provided in section 164;

(4) Losses incurred, as defined in subsection (b) (5) of this section;

(5) Capital losses to the extent provided in subchapter P (sec. 1201 and following, relating to capital gains and losses) plus losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Capital assets shall be considered as sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders to the extent that the gross receipts from their sale or exchange are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders in their capacity as such, losses paid, and expenses paid over the sum of interest, dividends, rents, and net premiums received. In the application of section 1211 for purposes of this section, the net capital loss for the taxable year shall be the amount by which losses for such year from sales or exchanges of capital assets exceeds the sum of the gains from such sales or exchanges and whichever of the following amounts is the lesser:

(A) The taxable income (computed without regard to gains or losses from sales or exchanges of capital assets or to the deductions provided in section 242 for partially tax-exempt interest); or

(B) Losses from the sale or exchange of capital assets sold or exchanged to obtain

refundable upon cancellation or expira- "taxable income" means the gross income

funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders;

(6) Debts in the nature of agency balances and bills receivable which become worthless within the taxable year;

(7) The amount of interest earned during the taxable year which under section 103 is excluded from gross income;

(8) The depreciation deduction allowed by section 167;

(9) Charitable, etc., contributions, as provided in section 170;

(10) Deductions (other than those specified in this subsection) as provided in part VI of subchapter B (sec. 161 and following, relating to itemized deductions for individuals and corporations);

(11) Dividends and similar distributions paid or declared to policyholders in their capacity as such, except in the case of a mutual fire insurance company described in section 831 (a). For purposes of the preceding sentence, the term "paid or declared" shall be construed according to the method of accounting regularly employed in keeping the books of the insurance company; and

(12) The special deductions allowed by part VIII of subchapter B (sec. 241 and following, relating to partially tax-exempt interest and to dividends received).

(d) *Taxable income of foreign insurance companies other than life or mutual and foreign mutual marine.* In the case of a foreign insurance company (other than a life or mutual insurance company), a foreign mutual marine insurance company, and a foreign mutual fire insurance company described in section 831 (a), the taxable income shall be the taxable income from sources within the United States. In the case of a company to which the preceding sentence applies, the deductions allowed in this section shall be allowed to the extent provided in subpart B of part II of subchapter N (sec. 881 and following) in the case of a foreign corporation engaged in trade or business within the United States.

(e) *Double deductions.* Nothing in this section shall permit the same item to be deducted more than once.

§ 1.832–1 Gross income.

(a) Gross income as defined in section 832(b)(1) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from the sale or other disposition of property, and all other items constituting gross income under section 61, except that in the case of a mutual fire insurance company described in § 1.831–1 the amount of single deposit premiums received, but not assessments, shall be excluded from gross income. Gross income does not include increase in liabilities during the year on account of reinsurance treaties, remittances from the home office of a foreign insurance company to the United States branch, borrowed money, or gross increase due to adjustments in book value of capital assets. The underwriting and investment exhibit is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code. By reason of the definition of investment income, miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared to shareholders in their capacity as such, home office remittances and receipts, and special deposits, are ignored. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been allowed as deductions for worthless debts or, having been previously so allowed, are recovered during the taxable year. In computing "premiums earned on insurance contracts during the taxable year" the amount of the unearned premiums shall include (1) life insurance reserves as defined in section 803(b) and § 1.803–1 pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 831 and not qualifying as a life insurance company under section 801, and (2) liability for return premiums under a rate credit or retrospective rating plan based on experience, such as the "War Department Insurance Rating Plan," and which return premiums are therefore not earned premiums. In computing "losses incurred" the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

(c) That part of the deduction for "losses incurred" which represents an adjustment to losses paid for salvage and reinsurance recoverable shall, except as hereinafter provided, include all salvage in course of liquidation, and all reinsurance in process of collection not otherwise taken into account as a reduction of losses paid, outstanding at the end of the taxable year. Salvage in course of liquidation includes all property (other than cash), real or personal, tangible or intangible, except that which may not be included by reason of express statutory provisions (or rules and regulations of an insurance department) of any State or Territory or the District of Columbia in which the company transacts business. Such salvage in course of liquidation shall be taken into account to the extent of the value thereof at the end of the taxable year as determined from a fair and reasonable estimate based upon either the facts in each case or the company's experience with similar cases. Cash received during the taxable year with respect to items of salvage or reinsurance shall be taken into account in computing losses paid during such taxable year.

§ 1.832–2 Deductions.

(a) The deductions allowable are specified in section 832(c) and by reason of the provisions of section 832(c)(10) and (12) include in addition certain deductions provided in sections 161, 241 and following. The deductions, however, are subject to the limitation provided in section 265, relating to expenses and interest in respect of tax-exempt income. The net operating loss deduction is computed under section 172 and the regulations thereunder. For the purposes of section 172, relating to net operating loss deduction, "gross income" shall mean gross income as defined in section 832 (b) (1) and the allowable deductions shall be those allowed by section 832 (c) with the exceptions and limitations set forth in section 172 (d). In addition to the deduction for capital losses provided in subchapter P (section 1201 and following), chapter 1 of the Code, insurance companies are allowed a deduction for losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. A special rule is provided for the application of the 5-year capital loss carryover provisions of section 1212. The deduction is the same as that allowed mutual insurance companies subject to the tax imposed by section 821, see section 822(c)(6) and the regulations thereunder. Insurance companies, other than mutual fire insurance companies described in § 1.831–1, are also allowed a deduction for dividends and similar distributions paid or declared to policyholders in their capacity as such. The deduction is otherwise the same as that allowed mutual insurance companies subject to the tax imposed by section 821, see section 823(2) and the regulations thereunder.

(b) Among the items which may not be deducted are income and profits taxes imposed by the United States, income and profits taxes imposed by any foreign country or possession of the United States (in cases where the company chooses to claim to any extent a credit for such taxes), taxes assessed against local benefits, decrease during the year due to adjustments in the book value of capital assets, decrease in liabilities during the year on account of reinsurance treaties, dividends paid to shareholders in their capacity as such, remittances to the home office of a foreign insurance company by the United States branch, and borrowed money repaid.

(c) In computing taxable income of insurance companies, losses sustained during the taxable year from the sale or other disposition of property are de-

ductible subject to the limitation contained in section 1211. Insurance companies are entitled to the alternative taxes provided in section 1201.

PROVISIONS OF GENERAL APPLICATION

§ 1.841 Statutory provisions; credit for foreign taxes.

SEC. 841. *Credit for foreign taxes.* The taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of a domestic insurance company subject to the tax imposed by section 802, 821, or 831, to the extent provided in the case of a domestic corporation in section 901 (relating to foreign tax credit). For purposes of the preceding sentence, the term "taxable income" as used in section 904 means—

(1) In the case of the tax imposed by section 802, the taxable income (as defined in section 803 (g)),

(2) In the case of the tax imposed by section 831, the taxable income (as defined in section 832 (a)).

§ 1.842 Statutory provisions; computation of gross income.

SEC. 842. *Computation of gross income.* The gross income of insurance companies subject to the tax imposed by section 802 or 831 shall not be determined in the manner provided in part I of subchapter N relating to determination of sources of income).

REGULATED INVESTMENT COMPANIES

§ 1.851 Statutory provisions; definition of regulated investment company.

SEC. 851. *Definition of regulated investment company*—(a) *General rule.* For purposes of this subtitle, the term "regulated investment company" means any domestic corporation (other than a personal holding company as defined in section 542)—

(1) Which, at all times during the taxable year, is registered under the Investment Company Act of 1940, as amended (54 Stat. 789; 15 U. S. C. 80 a–1 to 80 b–2), either as a management company or as a unit investment trust, or

(2) Which is a common trust fund or similar fund excluded by section 3 (c) (3) of such Act (15 U. S. C. 80 a–3 (c)) from the definition of "investment company" and is not included in the definition of "common trust fund" by section 584 (a).

(b) *Limitations.* A corporation shall not be considered a regulated investment company for any taxable year unless—

(1) It files with its return for the taxable year an election to be regulated investment company or has made such election for a previous taxable year which began after December 31, 1941;

(2) At least 90 percent of its gross income is derived from dividends, interest, and gains from the sale or other disposition of stock or securities;

(3) Less than 30 percent of its gross income is derived from the sale or other disposition of stock or securities held for less than 3 months; and

(4) At the close of each quarter of the taxable year—

(A) At least 50 percent of the value of its total assets is represented by—

(i) Cash and cash items (including receivables), Government securities and securities of other regulated investment companies, and

(ii) Other securities for purposes of this calculation limited, except and to the extent provided in subsection (e), in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer, and

(B) Not more than 25 percent of the value of its total assets is invested in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary or his delegate, to be engaged in the same or similar trades or businesses or related trades or businesses.

(c) *Rules applicable to subsection (b) (4).* For purposes of subsection (b) (4) and this subsection—

(1) In ascertaining the value of the taxpayer's investment in the securities of an issuer, for the purposes of subparagraph (B), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer, as determined under regulations prescribed by the Secretary or his delegate.

(2) The term "controls" means the ownership in a corporation of 20 percent or more of the total combined voting power of all classes of stock entitled to vote.

(3) The term "controlled group" means one or more chains of corporations connected through stock ownership with the taxpayer if—

(A) 20 percent or more of the total combined voting power of all classes of stock entitled to vote of each of the corporations (except the taxpayer) is owned directly by one or more of the other corporations, and

(B) The taxpayer owns directly 20 percent or more of the total combined voting power of all classes of stock entitled to vote, of at least one of the other corporations.

(4) The term "value" means, with respect to securities (other than those of majority-owned subsidiaries) for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the board of directors, except that in the case of securities of majority-owned subsidiaries which are investment companies such fair value shall not exceed market value or asset value, whichever is higher.

(5) All other terms shall have the same meaning as when used in the Investment Company Act of 1940, as amended.

(d) *Determination of status.* A corporation which meets the requirements of subsections (b) (4) and (c) at the close of any quarter shall not lose its status as a regulated investment company because of a discrepancy during a subsequent quarter between the value of its various investments and such requirements unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. A corporation which does not meet such requirements at the close of any quarter by reason of a discrepancy existing immediately after the acquisition of any security or other property which is wholly or partly the result of such acquisition during such quarter shall not lose its status for such quarter as a regulated investment company if such discrepancy is eliminated within 30 days after the close of such quarter and in such cases it shall be considered to have met such requirements at the close of such quarter for purposes of applying the preceding sentence.

(e) *Investment companies furnishing capital to development corporations*—(1) *General rule.* If the Securities and Exchange Commission determines, in accordance with regulations issued by it, and certifies to the Secretary or his delegate not earlier than 60 days prior to the close of the taxable year of a registered management company, that such investment company is principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, such investment company may, in the computation of 50 percent of the value of its assets under subparagraph (A) of subsection (b) (4) for any quarter of such taxable year, include the value of any securities of an issuer, whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer, the basis of which, when added to the basis of the investment company for securities of such issuer previously acquired, did not exceed 5 percent of the value of the total assets of the investment company at the time of the subsequent acquisition of securities. The preceding sentence shall not apply to the securities of an issuer if the investment company has continuously held any security of such issuer (or of any predecessor company of such issuer as determined under regulations prescribed by the Secretary or his delegate) for 10 or more years preceding such quarter of such taxable year.

(2) *Limitation.* The provisions of this subsection shall not apply at the close of any quarter of a taxable year to an investment company if at the close of such quarter more than 25 percent of the value of its total assets is represented by securities of issuers with respect to each of which the investment company holds more than 10 percent of the outstanding voting securities of such issuers and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 10 or more years preceding such quarter unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

(3) *Determination of status.* For purposes of this subsection, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years prior to such date it has acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or predecessor thereof. For purposes of the certification under this subsection, the Securities and Exchange Commission shall have authority to issue such rules, regulations and orders, and to conduct such investigations and hearings, either public or private, as it may deem appropriate.

(4) *Definitions.* The terms used in this subsection shall have the same meaning as in subsections (b) (4) and (c) of this section.

[Sec. 851 as amended by sec. 38, Technical Amendments Act 1958 (72 Stat. 1638)]

§ 1.851–1 Definition of regulated investment company.

(a) *In general.* The term "regulated investment company" is defined to mean any domestic corporation (other than a personal holding company as defined in section 542) which meets (1) the requirements of section 851(a) and paragraph (b) of this section, and (2) the limitations of section 851(b) and § 1.851–2. As to the definition of the term "corporation", see section 7701(a)(3).

(b) *Requirement.* To qualify as a regulated investment company, a corporation must be:

(1) Registered at all times during the taxable year, under the Investment Company Act of 1940, as amended (15 U.S.C. 80 a–1 to 80 b–2), either as a management company or a unit investment trust, or

(2) A common trust fund or similar fund excluded by section 3 (c) (3) of the Investment Company Act of 1940 (15 U. S. C. 80 a–3 (c)) from the definition of "investment company" and not included in the definition of "common trust fund" by section 584 (a).

§ 1.851–2 Limitations.

(a) *Election to be a regulated investment company.* Under the provisions of section 851(b)(1), a corporation, even though it satisfies the other requirements of subchapter M, chapter 1 of the Code, for the taxable year, will not be considered a regulated investment company for such year, within the meaning of subchapter M, unless it elects to be a regulated investment company for such taxable year, or has made such an election for a previous taxable year which began after December 31, 1941. The election shall be made by the taxpayer by computing income as a regulated investment company in its return for the first taxable year for which the election is applicable. No other method of making such election is permitted. An election once made is irrevocable for such taxable year and all succeeding taxable years.

(b) *Gross income requirement.* Section 851 (b) (2) and (3) provides that (1) at least 90 percent of the corporation's gross income for the taxable year must be derived from dividends, interest, and gains from the sale or other disposition of stocks or securities, and (2) less than 30 percent of its gross income must have been derived from the sale or other disposition of stock or securities held for less than three months. In determining the gross income requirements under section 851 (b) (2) and (3), a loss from the sale or other disposition of stock or securities does not enter into the computation. A determination of the period for which stock or securities have been held shall be governed by the provisions of section 1223 insofar as applicable.

(c) *Diversification of investments.* (1) Subparagraph (A) of section 851 (b) (4) requires that at the close of each quarter of the taxable year at least 50 percent of the value of the total assets of the taxpayer corporation be represented by one or more of the following:

(i) Cash and cash items, including receivables;

(ii) Government securities;

(iii) Securities of other regulated investment companies; or

(iv) Securities (other than those described in subdivisions (ii) and (iii) of this subparagraph) of any one or more issuers which meet the following limitations: (*a*) The entire amount of the securities of the issuer owned by the taxpayer corporation is not greater in value than 5 percent of the value of the total assets of the taxpayer corporation, and (*b*) the entire amount of the securities of such issuer owned by the taxpayer corporation does not represent more than 10 percent of the outstanding voting securities of such issuer. For the modification of the percentage limitations applicable in the case of certain venture capital investment companies, see section 851 (e) and § 1.851–6.

Assuming that at least 50 percent of the value of the total assets of the corporation satisfies the requirements specified in this subparagraph, and that the limiting provisions of subparagraph (B) of section 851 (b) (4) and subparagraph (2) of this paragraph are not violated, the corporation will satisfy the requirements of section 851 (b) (4), notwithstanding that the remaining assets do not satisfy the diversification requirements of subparagraph (A) of section 851 (b) (4). For example, a corporation may own all the stock of another corporation, provided it otherwise meets the requirements of subparagraphs (A) and (B) of section 851 (b) (4).

(2) Subparagraph (B) of section 851 (b) (4) prohibits the investment at the close of each quarter of the taxable year of more than 25 percent of the value of the total assets of the corporation (including the 50 percent or more mentioned in subparagraph (A) of section 851 (b) (4)) in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer company controls and which are engaged in the same or similar trades or businesses or related trades or businesses, including such issuers as are merely a part of a unit contributing to the completion and sale of a product or the rendering of a particular service. Two or more issuers are not considered as being in the same or similar trades or businesses merely because they are engaged in the broad field of manufacturing or of any other general classification of industry, but issuers shall be construed to be engaged in the same or similar trades or businesses if they are engaged in a distinct branch of business, trade, or manufacture in which they render the same kind of service or produce or deal in the same kind of product, and such service or products fulfill the same economic need. If two or more issuers produce more than one product or render more than one type of service, then the chief product or service of each shall be the basis for determining whether they are in the same trade or business.

§ 1.851–3 Rules applicable to section 851(b)(4).

In determining the value of the taxpayer's investment in the securities of any one issuer, for the purposes of subparagraph (B) of section 851(b)(4), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer. See example (4) in § 1.851–5. For purposes of §§ 1.851–2, 1.851–4, 1.851–5, and 1.851–6, the terms "controls", "controlled group", and "value" have the meaning assigned to them by section 851(c). All other terms used in such sections have the same meaning as when used in the Investment Company Act of 1940 (15 U.S.C., ch. 2D) or that act as amended.

§ 1.851–4 Determination of status.

With respect to the effect which certain discrepancies between the value of its various investments and the requirements of section 851 (b) (4) and paragraph (c) of § 1.851–2, or the effect that the elimination of such discrepancies will have on the status of a company as a regulated investment company for the purposes of subchapter M, chapter 1 of the Code, see section 851(d). A company claiming to be a regulated investment company shall keep sufficient records as to investments so as to be able to show that it has complied with the provisions of section 851 during the taxable year. Such records shall be kept at all times available for inspection by any internal revenue officer or employee and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

§ 1.851–5 Examples.

The provisions of section 851 may be illustrated by the following examples:

Example (1). Investment Company W at the close of its first quarter of the taxable year has its assets invested as follows:

	Percent
Cash	5
Government securities	10
Securities of regulated investment companies	20
Securities of Corporation A	10
Securities of Corporation B	15
Securities of Corporation C	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	20
Total	100

Investment Company W owns all of the voting stock of Corporations A and B, 15 percent of the voting stock of Corporation C, and less than 10 percent of the voting stock of the other corporations. None of the corporations is a member of a controlled group. Investment Company W meets the requirements under section 851 (b) (4) at the end of its first quarter. It complies with subparagraph (A) of section 851 (b) (4) since it has 55 percent of its assets invested as provided in such subparagraph. It complies with subparagraph (B) of section 851 (b) (4) since it does not have more than 25 percent of its assets invested in the securities of any one issuer, or of two or more issuers which it controls.

Example (2). Investment Company V at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash	10
Government securities	35
Securities of Corporation A	7
Securities of Corporation B	12
Securities of Corporation C	15
Securities of Corporation D	21
Total	100

Investment Company V fails to meet the requirements of subparagraph (A) of section 851 (b) (4) since its assets invested in Corporations A, B, C, and D exceed in each case 5 percent of the value of the total assets of the company at the close of the particular quarter.

Example (3). Investment Company X at the close of the particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash and Government securities	20
Securities of Corporation A	5
Securities of Corporation B	10
Securities of Corporation C	25
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	40
Total	100

Investment Company X owns more than 20 percent of the voting power of Corporations B and C and less than 10 percent of the voting power of all of the other corporations. Corporation B manufactures radios and Corporation C acts as its distributor and also distributes radios for other companies. Investment Company X fails to meet the requirements of subparagraph (B) of section 851 (b) (4) since it has 35 percent of its assets invested in the securities of two issuers which it controls and which are engaged in related trades or businesses.

Example (4). Investment Company Y at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash and Government securities	15
Securities of Corporation K (a regulated investment company)	30
Securities of Corporation A	10
Securities of Corporation B	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	25
Total	100

Corporation K has 20 percent of its assets invested in Corporation L and Corporation L has 40 percent of its assets invested in Corporation B. Corporation A also has 30 percent of its assets invested in Corporation B, and owns more than 20 percent of the voting power in Corporation B. Investment Company Y owns more than 20 percent of the voting power of Corporations A and K. Corporation K owns more than 20 percent of the voting power of Corporation L, and Corporation L owns more than 20 percent of the voting power of Corporation L. Investment Company Y is disqualified under subparagraph (B) of section 851 (b) (4) since more than 25 percent of its assets are considered invested in Corporation B as shown by the following calculation:

Percentage of assets invested directly in Corporation B	20.0
Percentage invested through the controlled group, Y-K-L-B (40 percent of 20 percent of 30 percent)	2.4
Percentage invested in the controlled group, Y-A-B (30 percent of 10 percent)	3.0
Total percentage of assets of Investment Company Y invested in Corporation B	25.4

Example (5). Investment Company Z, which keeps its books and makes its returns on the basis of the calendar year, at the close of the first quarter of 1955 meets the requirements of section 851 (b) (4) and has 20 percent of its assets invested in Corporation A. Later during the taxable year it makes distributions to its shareholders and because of such distributions it finds at the close of the taxable year that it has more than 25 percent of its remaining assets invested in Corporation A. Investment Company Z does not lose its status as a regulated investment company for the taxable year 1955 because of such distributions, nor will it lose its status as a regulated investment company for 1956 or any subsequent year solely as a result of such distributions.

Example (6). Investment Company Q, which keeps its books and makes its returns on the basis of a calendar year, at the close of the first quarter of 1955, meets the requirements of section 851(b)(4) and has 20 percent of its assets invested in Corporation P. At the close of the taxable year 1955, it finds that it has more than 25 percent of its assets invested in Corporation P. This situation results entirely from fluctuations in the market values of the securities in Investment Company Q's portfolio and is not due in whole or in part to the acquisition of any security or other property. Corporation Q does not lose its status as a regulated investment company for the taxable year 1955 because of such fluctuations in the market values of the securities in its portfolio, nor will it lose its status as a regulated investment company for 1956 or any subsequent year solely as a result of such market value fluctuations.